Bank of America Merrill Lynch 2017 Insurance Conference
Voya Financial Fireside Chat Transcript

Voya Financial Participant:
Mike Smith, Chief Financial Officer

Host:
Seth Weiss, Bank of America Merrill Lynch

Seth: Mike recently became CFO in November, 2016. Mike held several other leadership roles prior to his current position, including CEO of the Insurance Solutions segment and Chief Risk Officer. Additionally, Mike is also overseeing the legacy Variable Annuities business, which I'm sure there'll be questions on today. So Mike, if we can do the transition to this mic, it'll be perfect.

Mike: Perfect. Good morning.

Seth: Thanks so much for joining.

Mike: Thank you. Glad to be here.

Seth: I think where I would like to start off actually is thinking about the ROE progression of the Ongoing Business, so there will be time for the CBVA I'm sure. But I'd like to talk about the Ongoing Business. And if we go back to the third quarter call, you reiterated your ROE target of 13.5 to 14.5 percent by 2018, a view you had again reiterated on the fourth quarter call. But back at the time in the third quarter you commented that you were increasing expense initiatives to counteract interest rate and equity market pressures that were greater than expected. So where do we stand on this target considering the post-election improvement in interest rates and markets?

Mike: Sure. Well, first, again, thank you and glad to be here this morning. I think the way to think about the progression of ROE is that we started out in 2015 with a plan that we announced at our Investor Day, that had made certain assumptions about how interest rates would move and we assumed they'd follow the forward curve from that point and we also assumed equity markets would grow at 7.5 percent of increase per year from that point. As our CEO, Rod Martin, says, you start out with a plan and then life happens. And what happened is that the path of interest rates did not follow the forward curves. In fact, it was flat and then it was down. And all that time, we're investing, putting new money to work. And so, that puts pressure on the margins that we expected in the original path that we had put forth.

Plus, the equity markets, while they've done pretty well, are still not quite at that level. And just to give you some perspective, the spot rate today is about 60 to 70 basis points less than what would have been predicted by the forward curve at that time. So when we talk about the pressure on ROC of the lower interest rates, it's the cumulative effect plus the fact that we're still investing money below where we would have expected to be and that pressure is 125 to 145 basis points relative to the ROC goal.

So, as I said, life happens, and what we've decided to do is in addition to the investment program that we announced back in 2015 of $350 million, we're also pursuing some additional cost savings initiatives that will allow us to have $50 million or more less expense in 2017 and $100 million or more in 2018. So we view that as a reaction to the market. It's also a way to make us more agile going forward as a company. We think we can simplify our organization; we can simplify the way we do things and be investing in the future to drive growth going forward.

Seth: The expense targets were I believe $60 million more than what was originally planned a year or two ago. How much visibility do you have on where these should flow through?

Mike: The short answer is a lot of the benefit is going to flow through the Retirement business. That's where most of the – that's probably the largest single expense center. So the benefit would naturally flow that way. Plus, a lot of our investment is aimed at the Retirement business. That's a key focus point for future growth. And a lot of the growth initiatives will, while they're improving the customer experience via digital capabilities, single sign-on, improved log-on experiences, improved deposit experiences, and so on, that will actually take out costs as well – so it has a double benefit.

I think, more broadly, there will be benefits in all the businesses. These are broad-ranging cost initiatives. It's not just in Retirement. And as I said earlier, it's really about making us a simpler, more agile company as we're able to respond more quickly and more efficiently to the changing environment going forward.

Seth: I think there's always a risk when you hear about expense initiatives and it has been a theme in the insurance world because of those macro pressures. But there's a risk that you're under-investing in the business. So how would you respond to that in terms of pulling expenses out while still having this eye on the future?

Mike: Well, the $350 million investment program over three years that we announced in 2015 is still in full force and we're still making those investments in digital capabilities and simplifying our IT environment and data analytics, improving the customer experience overall. So those had significant growth components, either near-term or even over the next three to five years in addition to cost saves. And so I view this as an incremental effort on top of what we were already doing. But we are very focused on maintaining our investment as we continue to practice good capital stewardship.

Seth: If I could shift to the Retirement segment and I think the investments in technology transition into this question. But how would you categorize Voya's brand in retirement? What is it that you feel you do better today than others? And with an eye on the future, what are you improving on?

Mike: Let me parse that into two pieces. First, from a brand, a pure brand metrics standpoint, Voya, we've made a significant investment since the IPO in establishing name recognition. We think that's been – it's achieved all that we wanted it to achieve. I think our level of awareness is consistent with peers in the industry. So we're very happy with where we are in terms of customer recognition.

As I think specifically now about retirement, I think we view ourselves as a premier solutions provider aimed at individuals and institutions and working with distribution partners across the industry. And I think we do that with a view to be agnostic when we're dealing with customers as to income or age. We have to serve not just the people in the C-suite, but we have to serve the people on the factory floor, for example, or the lower paid folks. And so we've built a set of solutions, the myOrangeMoney™ tool, improved other experiences. We have a wide range of ability to deliver advice to people, both human touch, automated, on the phone. I think ultimately we're aimed at helping people retire better and that's something we talk about consistently is how do we – and it's a key part of how we think about how we prioritize our initiatives is how are we helping our customers retire better.

Seth: And if we think of the different segments in retirement that you made, I think you commented it's across sort of the case size. You're also big in the not-for-profit education market. Where do you think the growth is going to come from? Where are you most optimistic?

Mike: I think we have a strong position across all of those markets, both from corporate, from small to mid all the way up to mega sized clients. Tax-exempt, we have a very strong position in education, in government, in healthcare, all those segments. I think there are opportunities for growth across all. I think most recently we've seen significant growth in net flows in our Corporate segment. We've had I think five quarters in a row of growth overall and in our Corporate segment we've had 21 out of the last 22 quarters have been positive net flow. So we see real opportunity there for us as we go forward.

Seth: And in terms of the repricing initiative that's been going on the last several years since you've gone public, where do we stand on those? What inning are we in on that?

Mike: The repricing initiative that we started talking about back around the time of the IPO is done. That's – we're not in any innings. The game's over and that's behind us. But the way I think about that is that was kind of a refresh of approaching our existing case book with a new philosophy around pricing and it set the stage for what's to come, which is an ongoing activity, ongoing evaluation of our in force block, working with our clients and customers to be sure we're delivering on the promises that we've made. But in an environment where we have with the compressed spreads, reduced interest rates, we're going to continue to look for ways to improve the ongoing profitability of those clients.

So repricing is something that happens all the time. It never stops. I think what we talked about as an initiative was sort of a very clear focus on changing the approach that had been used in the past to be more focused frankly on profitability and less focused on just maintaining the top line.

Seth: And if you think about this in a competitive frame, in the P&C world there's always talk of where we are in the cycle. I think there are cycles also in the life and retirement world, maybe not as defined. But where are we in that cycle as you look at competition? Do you think pricing is still moving rational or is there any pickup in competition?

Mike: Look, I think, overall, that you should expect continued competitive pressure. Scale is important. We think we have given our market position and we think we're in a good spot there. And so I think the ability to drive lower unit costs and take that to a combination of lower costs for customers as well as improved profitability, that's I think where we want to be.

I don't know that I – I think, I've tended to think that people say markets are irrational when they lose a client and they think the markets are fine when they win the client. The retirement business is not so cyclical. It is just sort of a steady, I think, march toward lower and lower fees but that's because we're getting better and better. We have better processes. We have lower cost per unit. We're able to share that with the customers and with the shareholders.

Seth: I think it's been a good story in terms of the ROE progression. I would argue rightfully or wrongfully, CBVA is probably driving the stock to a large degree. I'd like to transition to a couple questions there.

Mike: Sure.

Seth: The biggest question is opportunities to de-risk given the rise in rates and how do you balance that all and what do your options look like today?

Mike: For us, all options are on the table and we've consistently looked for ways to either offload the risk or reduce the runoff of the risk more quickly or defease the risk through our hedging programs. All of those things are consistently being evaluated. In the context of higher rates, that makes a potential broader deal, where we work with a third party to take on a bigger slice of the risk. It makes it more economic.

But overriding that, we want to be good stewards of capital. We want to do things that make sense for the shareholder over the longer run. And so I think we need more of an increase in interest rates before that economic picture becomes more reasonable.

So we view that point at which the market values that outside parties use to evaluate these liabilities when compared to the resources we have. If interest rates get above the 10-Year say at 3 percent, that's when it starts to become more tractable. But I should hasten to say it's you've got to have a buyer and a seller and there's got to be a negotiation and ultimately an agreed upon price. And that will also be determined by how many sellers are in the market, [and] how many buyers are in the market at the time. So we're in regular contact with a lot of different bankers and with other third parties to try and identify what those kind of solutions can look like, not only today, but in the future.

Seth: And that's interesting. I've heard that 3 percent threshold from you in the past. And I suppose underlying that there's assumptions that you have for the book of business and then assumptions that buyers have and it seems like there's a disconnect there. I suppose if we do see rates get to 3-plus percent, is there a risk that potential buyers of the business would then raise their expectations further or do you think that bid ask spread would actually narrow?

Mike: I think the way to think about this is in two major components. First is the level of – if interest rates drives the difference between a market value view of liabilities and the statutory reserves and/or capital that we're holding. So market value is much more sensitive to changes in interest rates than are the statutory capital and, ultimately, the determination of the resources we have supporting the block. So, from a buyer's perspective, if the market value of liabilities reaches the level of statutory reserves that's when that becomes more economic for us. We can transfer those resources and that covers it.

The second part is policyholder behavior and that's where there's probably a broader potential for bid ask. But back in 2011, 2012, before the IPO, we took a number of very large assumption adjustments. $2.7 billion of additional capital was put to the business. We made very, I think, appropriate adjustments with a margin for conservatism in the capital and statutory calculations. So I think the bid ask there is narrowing because we've had significant development of experience.

In 2011, we were still trying to figure out what the post-crisis world would look like in assumptions. Now, I think, there's a lot of experience that we have, that the industry has. I think there's an increasing level of comfort. I think that will also help to reduce the bid ask going forward.

Seth: I think one thing that gets obscured in terms of the runoff is if you look at account value that doesn't really tell the picture. If equity markets go up, that's good for you but it doesn't lead to the runoff there. But in terms of actual policies, we've seen a nice runoff there over the last few years. You've had several programs in place, Enhanced Annuitization programs. You recently launched an Enhance Surrender Value program and I think it's the first one of those that you've done. I'm curious if you could speak about how that has progressed since it's been launched.

Mike: Sure. Let's first start with just fill in some numbers around the run-off. We were over 600,000 policies before the IPO. We're now at 320,000 policies as of the end of the fourth quarter. The account value was about $45 billion give or take. Now it's about $34 or $33 as of the end of the fourth quarter. To your point, equity markets and/or fixed income accounts have grown and the average account value of the customer has grown. That's good over the long run. It reduces the risk that we have.

So, that block just by its nature is running off at about 10 percent a year in terms of policy counts. What we've done with the enhancement programs, first, a series and we've done four separate income enhancement offers. Those have resulted in $1.5 billion of account value run-off. Those were done over a couple of, I think over three years, one or two in each year. And what we did was we went to the owners of our Guaranteed Minimum Income Benefits products and said, "Look, if you take the income benefit right now and convert from a product where we have equity exposure and long-term capital volatility, to one where, a product where you're just taking a payout stream, you lose the equity volatility and it's simply a matter of matching cash flows and the mortality risk, one we're much more comfortable with and I think the industry is much more comfortable with. If you take -- now we'll give you an extra 5 or 10 percent to your income stream. So if you would've gotten $1,000 a month, you're going to get $1,100 a month at the 10 percent enhancement.

That's what we've done so far. We've offered that to all of our GMIB policy holders. Now what we're doing is, we're offering an enhanced surrender value to about half of the GMIB. It's about 50,000 customers. And what that means is they've been given a chance to take the annuity first at an enhanced level. And now we're going to them and saying, look, if you would like to just cash out, we'll give you a portion of the difference between your actual account value and the benefit base that would be used to calculate your income stream. So essentially, they'll be able to get a significant, potentially significantly enhanced version of their account value. On average, it's about a 30 percent enhancement over their account value.

Now remember, as we, as policyholders take that, we'll be able to release the GMIB related reserves, the living benefits reserves to help offset that and we view it as a capital-neutral kind of event. So the way that'll actually work for the policyholder is it's the account value plus 55 percent of the difference between the benefit base and the account value. That's what they'll be able to get.

Anecdotally, when we first made the income enhancers, enhancement offers, policyholders said, "Well, you know, I don't really want this but if you offered us a buyout I might take it." So, this is a response in many ways to what customers were looking for. And we're very comfortable that having offered them and in some cases the folks getting this Enhanced Surrender Value have been offered it twice, giving them the chance to take a different stream of benefit from the product is a reasonable and an appropriate way to go at it.

In terms of results, [it's] too early. I mean we started the offer in late January. We're just now ourselves starting to get very early returns. I think I'd only characterize it as nothing super-surprising that has emerged at this point. But the offer doesn't close until the end of March. So on the first quarter call we'll be able to give a full accounting of the results of the program. Look, it's again consistent with our approach of trying to reduce the risk wherever we can, reduce the size of the CBVA and manage the risk as best we can.

Seth: And from Voya's perspective, would you consider yourselves agnostic between the enhanced income solution versus the enhanced surrender solution that's being given?

Mike: I think we view it more from the standpoint of what do the customers need. And I think that's – for some customers the income stream is the perfect solution; it depends on their specific situation. For others, they may need liquidity; they may no longer need the income stream. So I think we view it as, maybe we could view it as agnostic, but [it's] more about trying to provide options for customers.

Seth: One last one on the CBVA and you have a relatively large vintage of GMIB business that starts to reach caps in the next three to four years in terms of the guaranteed benefits. How sensitive might those reserves be if you start to see a big pickup in utilization on those policies?

Mike: The way to – let me back up and for those who are not – can't speak CBVA ease – let me try and explain what we're talking about here. When these policies were issued the promise was that the benefit base would grow at 7 percent a year at least from initial, from the initial premium. That amount of benefit base was capped and it depended, depending on which particular version you bought that cap could range anywhere from two times to three times the initial premium. At 7 percent a year that means you hit the two times cap at about year 10, you hit the three times cap at about year 17.

So, what we do in our models is we make assumptions about how people will utilize the annuity at the time that it hits the maximum and then thereafter. We have already seen those two times policyholders. Those that are limited at two times have gone through that experience. We've seen how they react to the availability of the income stream, as well as going through the maximum period. We've built that into our assumptions. We've used industry experience, where available to help us, help guide and calibrate our assumptions. And so, we feel like we've got a pretty strong set of experiences, experience that helps us set that increased expectation of utilization.

So the models reflect a significant increase. And so the risk is that it's even more than the increase that we've assumed. But I think we're pretty comfortable given the experience we have, given not only on our own block, but in industry, we're pretty comfortable that we're going to – that we've got a good bead on it. Time will tell. But I think we're comfortable.

But the simple fact that people are utilizing it is not a bad thing. It's only if it's different than what we've predicted in the model.

Seth: I want to pause to see if we have questions from the audience. I'll go through a few others here. Capital management, I believe as of year-end you have over $900 million of excess capital. Are there any binding constraints in terms of being able to access that and return it?

Mike: In addition to the excess capital position of $941 million, we have a share buyback authorization of $633 million. That's $33 million from a prior authorization and $600 million from a more recent one. Our plan is to dividend up most of that excess [capital] over the course of the year. The majority of that will happen in the second quarter. And we're going to be good stewards of capital. We've got – we've returned over the last, since IPO I think we're now over $3 billion in capital or 35 percent of our market cap. So, I think we're continuing down that path we've been on. We're investing in the business and I think we like the flexibility that we have with a strong capital position.

Seth: And if we think about capital management priorities, how are you thinking in terms of first, the dividends, and then, second, appetite for acquisitions?

Mike: In addition to the investments we're making just in our own organic growth and improving our capabilities, I think and we view share buybacks as the most logical/best use of capital right now given where our relative value of the stock versus what we think the company is worth. So we think that's a good use of capital at this point. At some point in the future we expect to increase the dividend.

And then in terms of M&A, we don't need to do an acquisition to achieve the goals that we've set for ourselves. We're very comfortable that we'll be able to achieve the ROC of 11.5 to 12.5, ROE of 13.5 to 14.5 without doing an acquisition. So to the extent we might do one, I would do something in that space. I would think it would be relatively small, sort of a bolt-on acquisition, maybe an additional capability in say Investment Management, but more in the nature of adding things that we currently don't have to round out our portfolio.

Seth: Maybe on the Individual Life business, you made several reinsurance agreements, refinanced some redundant reserves. Can you describe the improvements made on both the earnings and then also the capital side?

Mike: I think of these in two pieces. First is that we reinsured two large blocks. It was something like 40 percent of our in-force and released in two chunks over $400 million of capital and those were done in 2014 and 2015. I think those were largely responsible for the increase in ROE from, I think, in 2013, it was under 5 to the result this year of 6.6 in ROC on the life business. So those were blocks that had low returns for us. They were drags on the overall ROC. And so, we were able to find a reinsurance partner that could take on that risk and sort of addition by subtraction in a lot of ways.

Most of that activity is done because we've sort of – we've examined the blocks thoroughly and there aren't a lot of other blocks that are significantly below the overall ROC that we could sort of parcel off and sell. That wouldn't be logical for an option. So what we've done more recently is some of the refinancing or some of the financing that we've done of redundant reserve has been restructured. And I think a little context is helpful to understand the magnitude of the opportunity here.

We had a number of redundant reserve financing deals done with third parties that had to be restruck leading into the IPO because of change of control provisions. And so, at that time there was a lot of uncertainty about the company.

We also were up against a hard deadline. And so, we wound up having to do some financing at fairly high rates. And so there is a significant gap between current market financing of redundant reserves and some of the rates that we had on the books; and that's a drag on ROC. So we've been able to renegotiate some of our refinancing. In particular, we announced last – a few quarters ago, an improvement in one deal that would be an ROC improvement for the life business of 150 to 200 basis points and that's going to come both by releasing capital – because of the way the deal has been structured, as well as reducing the overall cost of the financing. And the relationship there is two-thirds of the benefit comes from the capital and a third comes from the earnings.

Seth: And is that, that capital benefit, is that in your excess $940 million you have or...?

Mike: No. That's going to show up over time in GAAP capital and it's different than the statutory.

Seth: On the group benefits side, I guess just a question from updated guidance in the quarter. And it's really a slight update. But medical stop loss has really been very profitable for you. You've now started to guide towards the loss ratio being at the higher end of your range. I'm just curious if we could talk about that business and what changed year-over-year.

Mike: First off, we enjoyed just spectacularly good loss ratios in 2014 and 2015 and we were consistently saying this isn't going to continue. It's a competitive market. Not only do investors and shareholders see our results but customers see our results and their consultants see our results. And so that leads to – and competitors see our results and so that leads to a repricing.

This business has repriced every single year. We go out to bid typically in the fall: most cases are rebid. So you would expect that given that experience that there would be some pressure upwards on the loss ratio over time and we think that's expected.

Now what we're seeing in the 2016 block is the pace of claims that have been reported is a little bit higher than we had been seeing. But we're not done with the, in particularly, the largest portion of that block. We won't really have a full sense of the total claims experience for that piece until probably the end of the first quarter. So that will give us a sense of where we ultimately are. It's coming in a little, as I said, a little bit toward the higher end of the range. But there are also some unknowns. This is about how quickly claims get reported and we won't know the ultimate level of claims until we're – time has, enough time has elapsed. It could be that claims are just being reported faster because of improvements in technology and some of the things that we've done. It may be that just the overall level of claims is going to be higher and toward that higher end.

I think the other way to think about this is, and you mentioned cycles earlier, there's a little bit of a cyclicality here where the Stop Loss business is good and then competitors respond, customers react, they seek better pricing. That puts pressure. Over the course of a couple of years we can then go back and reprice and the market can settle this back down again to something to the closer end of the range. But that's the – our sense is that we're going to be in the 78 to 80 kind of range for the Stop Loss business in '17.

Seth: Great. I'll take one more poll from the audience. One last question. It's a quick question or I'll try to make it quick. Just NAIC and Oliver Wyman, it's a fluid situation or fluid process right now. What are your expectations for timing of this proposal? And then, if you could talk about just how Voya is positioned within that initial proposal maybe.

Mike: So there's – I won't go through all the details but there are certainly a lot of details to work through and this is one where the details really, really matter. So we're actively engaged and working with others in the industry, with regulators in helping to craft an appropriate solution. We think the overall goal of creating consistency and transparency across VA writers is a good thing for the industry and a good thing for Voya.

In terms of timing, I think there are probably three effective dates that are possible. One is January 1, 2018. The second is December 31, 2018. The third is January 1, 2019. I think we're at the point where January 1, 2018 seems really unlikely. It's probably more likely to be '18 or '19. And the other thing to keep in mind is typically when there have been changes, like with the AG-43 for example, there was a phase-in period and that allowed companies time to move from where they are to the new rule. So I think when we have a better sense of the rules or where they're likely to come out, right now there's I think we count 14 different things that could – that are under consideration and there are plus and minuses on both sides of almost every one of those.

So a lot more to come. We'll be watching it carefully and really engaged.

Seth: Great. Thank you so much.

Mike: Thank you, Seth.