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VOYA - Q3 2016 Voya Financial Inc Earnings Call

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PRESENTATION

Editor

Audio in progress.

Darin Arita - *Voya Financial, Inc. - SVP, Head of IR*

Thank you, Keith, and good morning, everyone. Welcome to Voya Financial's Third Quarter 2016 Conference Call. A slide presentation for this call is available on our website at investors.voya.com or via the webcast.

Turning to Slide 2. On today's call, we will be making forward-looking statements. Except with respect to historical information, statements made in this conference call constitute forward-looking statements within the meaning of federal securities laws, including statements relating to trends in the company's operations and financial results and the business and the products of the company and its subsidiary. Voya 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 from time-to-time in Voya Financial's filings with the U.S. Securities and Exchange Commission.

Slide 2 also notes that the call today includes non-GAAP financial measures. In particular, all references on this call to ROE, return on equity; ROC, return on capital; or other measures containing those terms are to ongoing business adjusted operating return on equity or return on capital, as applicable, which are each non-GAAP financial measures. An explanation of how we calculate these and other non-GAAP financial measures and reconciliations to the most directly comparable GAAP measures can be found in the press release and quarterly investor supplement available on our website at investors.voya.com.

Joining me this morning on the call are Rod Martin, Voya Financial's Chairman and Chief Executive Officer; Alain Karaoglan, Voya Financial's Chief Operating Officer; and Ewout Steenbergen, Voya Financial's Chief Financial Officer. After their prepared remarks, we will take your questions.

Also here with us today to participate in the Q&A session are other senior members of management. Charlie Nelson, Chief Executive Officer of Retirement; Carolyn Johnson, Chief Executive Officer of Annuities and Individual Life; and Mike Smith, who will become our Chief Financial Officer on November 7.

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With that, let's go to slide 3 and I will turn the call over to Rod.

Rod Martin - *Voya Financial, Inc. - Chairman, CEO*

Good morning. Let's begin on slide 4 with some key themes.

During the third quarter, we continued to execute on our plans to drive greater value for all of our stakeholders. We had strong sales momentum across our Ongoing Business and our trailing 12-month ROE grew 60 basis points to 12.1%.

At the same time, we are taking proactive measures to simplify our organization, improve our competitive position, and achieve our financial goals. These actions are consistent with the approach and philosophy we demonstrated leading up to and since our IPO. They include, for example, reallocating resources to products that align with customer demands and offer differentiation in the market, while still providing attractive growth and return on capital for shareholders. Another example is directing capital to our higher return businesses, while still ensuring we are meeting customer and distribution partner needs.

Our actions also include an enterprise-wide effort to simplify our organization. We see opportunities such as having our Annuities and Individual Life businesses more closely aligned to reduce complexity, increase our competitiveness, and better serve our distribution partners and customers.

As we announced this morning, we believe our actions will enable us to achieve higher run rate cost savings. We now plan to achieve annual run rate cost savings of at least $100 million, to be realized in 2018 and subsequent years. This represents an increase from our prior plans to achieve $30 million to $40 million in annual run rate cost savings. These savings will result from our focus on consolidating our IT platforms, digitizing processes, better leveraging resources, such as the combination of Annuities and Individual Life.

Overall, we expect in the near to medium term our actions will offset some of the pressure from low rates and help us achieve our 2018 ROE target of 13.5% to 14.5%.

In the long term, our efforts will create a more agile company, with improved customer experience and greater ability to adapt to an evolving regulatory and macroeconomic environment. We will build on our track record of taking action to improve our competitiveness.

And we are taking these actions with a solid capital foundation. At the end of the third quarter, we had $978 million of excess capital. During the fourth quarter, we plan to enter into a $200 million discounted share repurchase agreement. And we will continue to be opportunistic with share repurchases. Our Board has authorized an additional $600 million of repurchases, which we plan to utilize through the end of 2017.

Equally important, our Closed Block Variable Annuity hedge program continued to protect regulatory and rating agency capital from market movements during the quarter. We lowered our long-term interest rate assumption to 3.75% for regulatory and rating agency purposes in connection with our annual assumption review. And at the end of the quarter, the resources backing the block continued to exceed regulatory and rating agency requirements.

We also continue to take actions to reduce the size of the block. Following the completion of our third enhanced annuitization offer in the quarter, we launched a fourth offer, targeting the 2003 vintage. This represents approximately half of the guaranteed minimum income benefit block. In total, our first three offers have accelerated a cumulative run-off of close to $1 billion.

In addition, on October 24, we filed a GMIB enhanced surrender value offer with the SEC. Since we are still in the SEC registration process, we are limited in what we could say, but unlike previous offers, this offer would provide an enhancement to policyholders' cash surrender value in exchange for surrendering the contract.

If we were to proceed, we would make the offer to some of our policyholders who previously received our enhanced annuitization offers, but declined to participate. We believe this provides an option for those customers who may see more value in liquidity than in the potential income stream of the annuity. Assuming we're in a position to commence the offer, we will provide more details during our earnings call in February.

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Moving to slide 5, we reported operating earnings per share of $0.37 for the third quarter. There were several items that, on a net basis, reduced earnings by $0.42 per share. The most notable was due to the DAC and VOBA and other intangibles unlocking related to our annual review of actuarial assumptions and models. There were a number of drivers for this, including a change in our long-term interest rate assumption, and Ewout will provide more details on that shortly.

In our Ongoing Business, we generated $330 million of adjusted operating earnings. Our ROE for the trailing 12 months improved 60 basis points from June 30. Adjusting for prepayment fees and alternative investment income relative to our long-term expectations, our ROE grew by 30 basis points.

Also in the quarter, we expanded the responsibilities of our leadership team. Alain now has the oversight of all of our Ongoing Businesses, which will help ensure Voya truly operates as a customer-centric organization. We also expanded Carolyn Johnson's role. We welcomed Maggie Parent and Nan Ferrara to our executive team. Christine Hurtsellers became our new CEO of Investment Management and Mike Smith will become our new CFO on November 7.

The diversity and bench strength of our executive committee provides us with experiences and knowledge that will help deliver value to all of our stakeholders.

Moving forward, we remain focused on all of our initiatives and the investments we are making in our Ongoing Business to drive greater returns. We will continue to be diligent in our focus on execution, to achieve our goals and to help Americans get ready to Retire Better.

I will now turn it over to Alain, who will give us some details on our actions.

Alain Karaoglan - *Voya Financial, Inc. - COO*

Good morning. Let's go to slide 7.

Our return on equity and return on capital for the 12 months ended September 30 were 12.1% and 10%, respectively. Adjusting for prepayment and alternative investment income relative to our long-term expectations, our returns increased nicely from year-end and the second quarter. We have achieved this improvement despite market headwinds.

Looking ahead, the effect of the lower interest rate environment and equity market has created a gap of approximately 140 basis points to our original 2018 return on capital plan. Recall from our June 2015 Investor Day that we had estimated a 70 to 90 basis points drag on return on capital from interest rates. The additional cost savings, as Rod discussed, will partially offset the effect of lower interest rates and lower than planned equity market appreciation.

In addition, the execution of our capital initiatives has been better than expected. We expect our Ongoing Business capital to end 2018 roughly flat from our 2015 starting point of $8.7 billion. We had initially expected our GAAP capital to rise slightly over the period. Our initiatives in Annuities and Individual Life are the primary drivers of improvement versus our initial expectations.

Because of these initiatives and despite the headwinds we face, we expect to achieve our 2018 Ongoing Business returns target. We are affirming the individual return targets for four out of our five Ongoing Business segments and revising our return on capital target for one of the segments.

Separate from these initiatives, we are in the process of reviewing our target capital allocation by operating segment, which could affect the GAAP capital allocation. While we target an overall capital level of 425% RBC, our capital allocation process balances our view of risk and external formulas, such as risk-based capital and rating agencies. This process can result in a particular segment being above or below the 425% level.

Changing the capital allocation could affect the 2018 return on capital target for the segments, and while work is still underway, we expect a lower capital allocation to Retirement and increased capital allocation to our other segments. This change would not affect the overall return on capital target for the Ongoing Business.

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On slide 8, we provide more detail of the $100 million of annual run rate cost savings that we expect to achieve from simplifying the organization. In addition to offsetting some of the headwind from low interest rates, our efforts to increase organizational agility and efficiency will help us compete more effectively and deliver an enhanced experience to our customers.

The pipeline of opportunities includes consolidating the Annuities and Individual Life businesses, further emphasizing less capital-intensive products, migrating even more to an information technology cloud environment, and reducing the number of registered entities. We expect to incur at least $30 million of restructuring charges in the fourth quarter of 2016. These will be classified as non-operating expenses. We anticipate further charges through 2018, which we cannot quantify at this time.

On slide 9, we provide an update on our 2016 growth initiatives. In Retirement, we generated an 11% year-over-year increase in deposits in Small/Mid Corporate markets. This was driven by expanded distribution capabilities and increased sales force productivity. In Tax-Exempt markets, third-quarter deposits were up 69% year over year, helped by the funding of a large government plan.

In Investment Management, Institutional sales faced a difficult comparison with a large CLO closing in the third quarter of 2015. In October, we closed a $600 million CLO and won several sizable institutional mandates, which currently positions us well to meet our full-year institutional sales targets.

Retail intermediary sales, however, were up 16% year over year, reflecting growth in fixed income strategies. Our strong October retail sales gives us confidence that we are on track for a solid finish for the year and provide us with added momentum heading into 2017. We also note that our Affiliate-sourced sales increased 23% year-over-year, driven by strong demand for target date and stable value funds.

In Annuities, sales of fixed indexed annuities slowed in the third quarter, as we expected, reflecting our pricing discipline as interest rates declined. Year to date, however, sales increased 19%. Sales of investment-only products have increased for the second consecutive quarter, but remain below prior-year comparison.

In Employee Benefits, we grew our in-force premium by 6% year-over-year. We are seeing continued increased competition with new entrants in the Stop-Loss market. However, we remain committed to our underwriting and pricing discipline.

Let's look more closely at Retirement on slide 10. We reduced our 2018 return on capital targets to 9.5% to 10.5% from 11% to 12%, due largely to lower interest rates, the effect of our guaranteed minimum interest rate, and lower than planned equity market appreciation collectively, which we estimate to cost us approximately 250 basis points of return on capital.

To counteract these headwinds, we are pursuing additional opportunities to improve our return on capital, while continuing to execute on our existing initiatives. And here are a couple of examples. First, a large portion of the enterprise cost savings we expect to generate will benefit Retirement. Second, we have a team in place developing solutions to align our higher guaranteed minimum interest rate blocks of business with our corporate financial targets, where the effect of persistently low interest rates has been acute.

Also, as noted on the prior slide, we continue to have success with our Small/Mid, and Tax-Exempt markets growth initiatives. Momentum remains strong in our recordkeeping business with new mandates, such as the city of Los Angeles. This should lead to an improvement in recordkeeping fees in 2017, once the plans are fully transitioned.

Achieving Retirement's 2018 target will require significant focus on execution. We are confident in our ability to hit this target. We have a strong and experienced team that is transforming our franchise at the operational, financial, and cultural levels.

Moving to slide 11, in Investment Management, the operating margin, excluding the effect of investment capital, is slightly lower versus 2015. This reflects reduced fees from lower average assets under management, primarily due to the CBVA run-off and non-Voya managed retail outflows, as well as lower equity markets in the first quarter of 2016.

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We expect to achieve our 2018 margin target of 33% to 35%, which includes an expected contribution from investment capital of 200 basis points. We expect to generate positive Investment Management sourced net flows to achieve our 2018 target, driven by our diverse capabilities across an array of asset classes, coupled with strong investment performance.

Moving to slide 12, the return on capital for Annuities was approximately 9%. We expect to achieve our 2018 return on capital target as a result of three things -- enhancing operating efficiency and realizing cost savings from the integration with our Individual Life business; proactively managing our crediting rates to achieve our target profitability; and remaining focused on optimizing capital usage.

Turning to slide 13, we have made significant progress improving the return on capital for Individual Life, achieving 8.1% on a trailing 12-month basis. Assuming normal mortality experience in the fourth quarter of 2016, we expect the full-year 2016 return on capital to decline by approximately 100 basis points relative to the third quarter return on capital, as the unusually favorable mortality results from the fourth quarter of 2015 fall out of the trailing 12-month calculation.

We expect to achieve our 2018 return on capital target as a result of realizing cost savings from integrating with our Annuities business and the restructuring of our redundant reserve financing. As we have previously communicated, refinancing these reserves will increase the return on capital by 150 to 200 basis points. In 2017, approximately 70% of the benefit is expected to emerge, due to capital reduction of approximately $300 million. The remaining 30% will arise from lower financing costs of approximately $15 million to $20 million. Partially offsetting these initiatives are higher reinsurance costs and lower investment income, due to the continuation of the low rate environment.

Moving to slide 14, the return on capital for Employee Benefits has declined from full-year 2015, reflecting a normalization of loss ratios. Assuming normal claims experience for the fourth quarter of 2016, we expect the full-year 2016 return on capital to increase to within our 2018 return on capital targeted range of 23% to 25%, as results from the fourth quarter of 2015 fall out of the trailing 12-month calculation.

We expect to achieve our 2018 return on capital target as a result of continued growth across all major product lines, while maintaining our disciplined underwriting approach.

In summary, we are executing on our previously announced initiatives and are focusing on additional opportunities to improve returns. In our view, a large part of achieving our 2018 return goals remains within our control.

Now, I will turn it over to Ewout to go over our financial results. Ewout?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

Today, I will discuss our financial performance for the third quarter of 2016.

Slide 16, we highlight several key items that occurred during the quarter and other items to consider. Prepayment fee income was above our long-term expectations, while alternative investment income was slightly below. Fee income, particularly in Retirement and Investment Management, benefited from rising equity markets during the third quarter.

In Retirement, plan participants continued to shift assets from variable to fixed accounts, which partially offset fee income and acted as a drag on investment spreads and return on capital. In Individual Life, our mortality results were slightly unfavorable, due to elevated severity. In Employee Benefits, our loss ratios were in line with our annual target, with Stop- Loss at the higher end of the range. In our Voluntary business, we had a $17 million favorable reserve refinement.

As reported, in the corporate segment we incurred $29 million of the planned $350 million investment during the third quarter. We expect to incur $25 million to $35 million related to the strategic investment program in the fourth quarter.

Also, looking ahead to the fourth quarter, we anticipate an operating loss of approximately $20 million to $30 million in our Closed Block Other segment. This is related primarily to an accelerated run-off of the block that resulted in corresponding deferred prepayment penalties.

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Then slide 17, we conducted our annual review of assumptions and projection model inputs during the third quarter. Overall, the review had modest impacts on our balance sheet. Adjusting our expectation for future yields based on the current interest rate environment was the biggest driver of Ongoing Business GAAP adjustments. This includes revising our long-term interest rate assumption to 4.25% from 4.75%.

In our Closed Block Variable Annuity segment, we further lowered our long-term interest rate assumption to 3.75% from 4.75% for regulatory and rating agency purposes. We also updated our policyholder behavioral assumptions for this closed block. A favorable update to utilization rates on guaranteed minimum withdrawal benefit contracts offset an update to lapse rates, which are based on trailing three years of data.

And turning to slide 18, our quarterly Retirement net flows were positive for the fourth consecutive quarter. In Corporate Markets, we have generated net inflows for 20 of the last 21 quarters. These net flows have totaled nearly $6 billion over that period. Tax-Exempt Markets net flows also included the funding of a large government plan we mentioned last quarter.

Slide 19, Investment Management sourced net inflows were positive for a third consecutive quarter, reflecting continued client demand across a broad range of our products and solutions. These net flows have a higher revenue yield than the variable annuity outflows, which are primarily in indexed-based strategies.

Leveraging our investment track record, we also completed a $187 million sub-advisory replacement for a large cap equity fund in the quarter.

Slide 20, our Annuities Investment-Only products generated another quarter of net inflows. For Fixed Indexed Annuities, net flows were slightly negative, reflecting our pricing discipline. As interest rates fell to year lows at the end of the second quarter, we adjusted our caps and participation rates. We expect to improve our competitiveness in the fourth quarter, following the increase in interest rates. Our overall assets under management increased sequentially, helped by higher equity markets.

Slide 21, we experienced slightly unfavorable mortality in Individual Life, due to elevated severity. The graph on the left shows that our third quarter actual-to-expected mortality ratio was 94%. This is relative to our expected mortality ratio of 90%.

Moving to slide 22, our results remained strong in Employee Benefits. We remain focused on our underwriting and pricing discipline through the January renewal cycle.

Slide 23, our Closed Block Variable Annuity hedge program continues to perform as designed. During the quarter, the hedges offset the change in reserves. We had estimated available resources, which are entirely supported by hard assets, of $6.3 billion and statutory reserves of $5.3 billion at the end of the third quarter. The change in values from the second quarter was largely driven by higher equity market returns.

We continue to focus on protecting regulatory and rating agency capital. Our rating agency target is CTE 95, based on the S&P model, which is an aggregate calculation across all legal entities. As of the third quarter of 2016, we are sufficient at S&P's CTE 98 level, inclusive of our statutory long-term rate of 3.75%.

As a reminder, our equity market assumptions are prescribed by the regulators and adopted by the rating agencies. The difference between S&P's capital model at a CTE 95 versus CTE 98 has been approximately $400 million over the past two years. As has been our practice since the IPO, we continue to manage our capital to CTE 95 and do not intend to shift our target to CTE 98.

We also did not have a letter of credit need at September 30, and no letters of credit were issued. The annualized net outflow rate in this closed block was 12.7%, which included a 2.6% benefit from our third enhanced annuitization offer.

With respect to the National Association of Insurance Commissioners work on a revised variable annuity regulatory framework, it is too early for us to estimate the effects of the proposal. We can share a few thoughts.

First, we welcome the NAIC's efforts to bring transparency and comparability across the industry. Second, we are working closely with the ACLI to achieve these goals in a way that works well for both the regulators and the industry. Third, to the extent reserves and capital become more sensitive

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to interest rate changes under the new requirements, we believe we could increase the interest rate sensitivity of our hedged assets by adjusting our swaps position. Finally, we expect the NAIC to authorize another Quantitative Impact Study, which we will work through over the coming months, and we plan to remain active in working with the regulators on their VA reserve and capital reforms.

Slide 24, you can see that our regulatory and financial leverage ratios are strong and remain better than our targets. The RBC ratio increased to 468% at the end of September, mainly driven by statutory net income. On the right side of this slide, our debt to capital ratio as of the end of the third quarter was 23.3%.

On slide 25, our capital position is strong. Holding company liquidity stood at $828 million at the end of the third quarter. The middle chart shows our excess capital at $978 million, which consists of estimated statutory surplus and holding company liquidity above target. We will continue to evaluate all potential options to deploy excess capital that maximizes value for shareholders.

With that said, we view share repurchases as a significant way to generate value for shareholders. As Rod noted, we plan to launch a $200 million discounted share repurchase program with a third-party financial institution in the fourth quarter and we will have over $600 million available for additional repurchases through year-end 2017 with the new authorization.

In summary, we continue to take proactive steps to improve ROE and focus on cost management. We have a strong balance sheet with significant excess capital, and our Closed Block Variable Annuity hedges continue to protect regulatory and rating agency capital as we pursue additional de-risking measures.

With that, I will turn the call back to the operator, Keith, so we can take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Ryan Krueger, KBW.

Ryan Krueger - *Keefe, Bruyette & Woods, Inc. - Analyst*

First one was on the 2018 ROC and ROE targets, for Alain. I guess just to clarify, the total -- the reiteration of the 13.5% to 14.5% target, did you update -- I guess, is that updated for a different and lower interest rate environment? Can you just review that, please?

Alain Karaoglan - *Voya Financial, Inc. - COO*

Thank you, Ryan. Yes, the 2018 ROC target of 13.5% to 14.5% is updated for the lower interest rate environment and the equity market that is lower than what we had anticipated a year and a half ago.

Ryan Krueger - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, are you assuming -- can you tell us more about what interest rates are assumed in that?

Alain Karaoglan - *Voya Financial, Inc. - COO*

We're assuming the forward curve as of July 31, 2016.

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Ryan Krueger - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, thanks. And then for Ewout on CBVA, I guess couple things. One, the reduction to 3.75% from 4.75% long-term interest rate assumption seems quite significant, but there were no negative statutory impacts from your review in aggregate. Can you talk more about why that was?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

Good morning, Ryan. Yes, indeed, that might feel counterintuitive, but let me explain why that is the case. On a statutory basis, we lowered the long-term rate expectation for the 10-year treasury to 3.75%, and what you see is that we have taken an additional prudency margin over and above management's best estimates that we apply on a GAAP basis of 4.25%.

On a statutory basis, we also have lowered a long-term expectation of shorter interest rate duration, so let's say a one-year treasury rate. That isn't really applicable on a GAAP basis, but on a statutory basis, that has an impact.

Lowering, in the same way, the short-term treasury rates as the long-term treasury rates has a counterintuitive effect because it means that the hedges we have on our books will become more valuable. So, think about the swaps position we have. We receive fixed. We pay floating. If the one-year treasury rates come down, it basically means a positive from our swaps positions and that is offsetting therefore a negative from the update of our long-term expectation of the 10-year treasury yields. So there are offsetting effects here, and the net of that was still a positive in terms of the overall assumption impact on a statutory basis for the Closed Block Variable Annuity.

Ryan Krueger - *Keefe, Bruyette & Woods, Inc. - Analyst*

And then, lastly, on the CTE98 comment in that S&P utilizes all resources across legal entities, is that -- at CTE98, is that including or is it double counting any of the capital you would be considering to be excess capital that would have been in the legal entity, the original statutory legal entity where the VA business is, or is it entirely separate from the excess capital estimates?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

That is entirely separate. What you see more is a benefit of diversification across multiple entities, but the excess capital that we have presented to you today is the real excess capital, and there is no double counting in that.

Ryan Krueger - *Keefe, Bruyette & Woods, Inc. - Analyst*

Thank you.

Operator

Nigel Dally, [Voya].

Nigel Dally - *Morgan Stanley - Analyst*

Morgan Stanley, actually. I also had a question with regard to the ROE goals. ROE goal of 13.5% to 14.5% remains unchanged, but you revised down the Retirement goal by 150 basis points. Now, Retirement is roughly half the capital of the ongoing operations and you haven't changed the return expectations for the other divisions, so if you're reducing your return to the largest division, keeping the other divisions unchanged, how do you still hit the overall firm-wide ROE goal? Getting there [is] some offsets, which I'm hoping you can discuss.

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Alain Karaoglan - *Voya Financial, Inc. - COO*

So arithmetically -- so, Nigel, I am glad to hear you're still with Morgan Stanley. The arithmetic calculation that you're going through are absolutely right. One of the segments is lower. It suggests that the other segments are higher.

So what is happening? Our cost initiatives are having an impact overall in terms of further lowering our costs, and as I mentioned during my comments, our capital initiatives are coming up higher than what we had anticipated and that's affecting primarily the Annuities and the Individual Life businesses, and so we are continuing to reduce the capital intensity of the product.

And so, when you add it all up, the return on equity of 13.5% to 14.5% for the overall Ongoing Business is achieved while achieving our Retirement business return on capital that is lower than it would have been a year and a half ago.

Nigel Dally - *Morgan Stanley - Analyst*

Okay, great. Thank you.

Operator

Tom Gallagher, Evercore ISI.

Tom Gallagher - *Evercore ISI - Analyst*

Just to follow up on Nigel's question, Alain, if I could, on Retirement. So the 150 basis-point reduction in segment ROE guidance, did you say that assumes a lower capital allocation to that division? And the amount of capital you are contemplating being allocated there, is that meaningful or is that not very meaningful when thinking about where ROE in that segment is going?

Alain Karaoglan - *Voya Financial, Inc. - COO*

So just to step back, the decrease in return on capital in the Retirement segment is based on the current capital allocation that we have. And as I mentioned in my comments, the cost of interest rates being lower than expected and equity markets have hurt the return on capital of Retirement, will hurt by 250 basis points. And that is what we have to overcome in order to continuously improve the ROC.

In terms of the capital going forward, we are undergoing a review of our capital allocation. It doesn't change our capital for the ongoing overall segment, but to the extent that we were to change the capital allocation to each of the segments, the return on capital of this segment would change. And what I have said is that currently the capital allocation on Retirement is higher, higher, than 425% RBC.

Tom Gallagher - *Evercore ISI - Analyst*

Right, but, Alain, the 150 basis-point reduction is not including some benefit for lower assumed capital allocation, meaning -- I just want to make sure there's not a larger pro-forma reduction in ROE goal here, if you know what I mean.

Alain Karaoglan - *Voya Financial, Inc. - COO*

No, Tom, you should know us well. No, it is based on the same capital allocation that we had before. There is no reduction of capital to the Retirement business based on the targets that we have.

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Tom Gallagher - *Evercore ISI - Analyst*

Okay. And then, Ewout, just on the CBVA, just a follow-up to Ryan's question. So the 100 basis-point downward adjustment, can you talk about -- I listened to your answer. That made sense that you are assuming a bigger derivative gain based on interest rates going down. But I would assume the derivative gain would be more of a near-term impact; the impact of assuming interest rates permanently are 100 basis points lower would be a much more pronounced impact to the size of the reserves.

So I guess I'm just having trouble conceptualizing that. So my question on it is, can you talk about the gross changes to reserves that would have been driven on one hand by lower rates, how big? I don't know if you can size that at all in a broad sense for how big that change would have been, being then offset by favorable policyholder behavior impacts? And were those two things very sizable in either direction?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

Let me give you a little bit more disclosure on this, but, as you understand, we cannot provide you all the details of all the individual moving parts. But let me give you an answer more broadly with respect to what you see happening here.

First, let me go into policyholder behavioral assumptions. So we saw two large changes and updates during the quarter. The first was an update with respect to utilization rates of withdrawal benefits. We have seen policyholders starting their withdrawals at a later point in time. That is economically a positive development for the Company, and that was therefore a positive assumption update.

And that was offset by an update of our lapse assumptions. You are aware that our lapse assumptions are quite actual. We look at the actual experience over the last three years and we are truing up every quarter -- third quarter of every year, to the most recent experience over the past three years. We see a continuation of a decline of lapse rates, so that update was a negative.

The net of the two was still that positive policyholder behavioral update at the top end of the range of guidance we have provided before, so close to $150 million.

Then you see on a GAAP basis a negative for other impacts that was mostly driven by the change of the long-term rate assumption for the 10-year treasury yields to 4.25% on a GAAP basis, and that was a negative, and that is in line with the sensitivities we have provided before with respect to our long-term rates that we have disclosed in our 10-K and 10-Q.

And then on the statutory basis, the other assumptions, what you see there is those offsetting elements, so the long-term rate assumption update for the 10-year treasury was a negative and that was offset by a positive of the long-term rate assumption for the shorter-duration treasury rates, so, for example, the one-year rate, and that had to do with a more positive expectation of the economic value of our hedges under that new scenario.

So what you should see is we have adjusted the expectation of long-term rates for the full curve of rates, so not only the long end of the curve, but for the full curve has been reduced and are offsetting elements in that curve.

So, those two are offsetting and therefore you see still a net positive impact on the statutory basis for the closed block with respect to this update.

As you understand, to be at a 3.75% level on a statutory and rating agency basis, we believe, is a very important step for the Company and hopefully provides a lot of confidence in the actual capital position and resources we have put behind the Closed Block Variable Annuity.

Tom Gallagher - *Evercore ISI - Analyst*

Okay, thanks very much.

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Operator

John Nadel, Credit Suisse.

John Nadel - *Credit Suisse - Analyst*

If I look at slide 23 and I compare the statutory reserves and the CBVA, so they are down about $600 million quarter over quarter. If I use the numbers on page -- on slide 17, so about $175 million or so of that reduction is driven by the changes in assumptions. What is making up the difference, the other $400 million, $425 million or so? Is that surrender activity? Is that -- or is that just performance of the block?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

John, good morning. Let me answer your questions in two ways, because I think your question is first about the available resources for the Closed Block Variable Annuity at the level of $6.3 billion.

That has mostly come down based on increase in the equity markets during the quarter; therefore, our hedges have dropped off losses, as expected, in line with the offset we see on the liability side on a statutory and rating agency basis. So that is reducing the available resources, so that is purely driven by the equity-market impact on our hedge position.

There isn't really an impact from policyholder behavioral assumption on the resources, because then you have to look on slide 17 through the statutory line and you see the statutory impact of the assumptions was a positive, so the assumption update did not have a negative impact on the resources for CBVA.

The second part of your question is, I think, in relation to the excess capital position and why that has improved. That is really driven by, on a statutory basis, operating net income that we were able to generate over the quarter of approximately $245 million.

John Nadel - *Credit Suisse - Analyst*

Okay.

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

That $245 million pre-tax operating stat income, that drove the excess capital position up. As we have explained during the prepared remarks, we were not doing additional buyback activity during the quarter, so there was very little cash expense during the quarter, so therefore you see the excess capital going up by approximately $200 million during the third quarter itself.

John Nadel - *Credit Suisse - Analyst*

Okay, that is really helpful. And then, if I think about -- so you told us about the statutory decline or reduction in your long-term rate assumption. And you told us about the offset or at least partial offset impact on the hedges. What did the shorter-term or one-year equivalent treasury -- how much did you raise that assumption?

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Ewout Steenbergen - *Voya Financial, Inc. - CFO*

So the one-year treasury rate, and that is our long-term expectation of the one-year treasury rate, is 3%. We brought that down from 3.75% to 3%, so, again, the long-term rate assumption for the 10-year treasury rate we brought down to 4.25% and then on a statutory basis for the CBVA to 3.75%, and then the long-term expectation for one-year treasury, we have reduced that to 3.0%.

John Nadel - *Credit Suisse - Analyst*

Okay, you reduced the one-year to 3%, okay, got it. And then, last question is just last quarter you provided us with a bunch of stress scenarios around the CBVA. Is it just safe to assume that given there is no update to that disclosure that there is no material changes to those impacts?

Ewout Steenbergen - *Voya Financial, Inc. - CFO*

That's a correct understanding. The Company usually is providing updates to the long-term cash flow projections, the 50-year cash flow projections, both under deterministic and stochastic scenarios. At the first-quarter earnings call, we provided additional updates, given the low rate environment and the reduction of rates last quarter. But what you should see is in normal course of business an update again on those 50-year cash flows after the first-quarter 2017.

John Nadel - *Credit Suisse - Analyst*

Got it. Thanks very much.

Operator

Michael Kovac, Goldman Sachs.

Michael Kovac - *Goldman Sachs - Analyst*

Thanks for taking the question, and good morning. Wanted to follow up a little bit on the cost initiatives and specifically if you could provide us some more detail. I know you haven't given the actual dollar amounts that will be spent upfront, but some more detail in terms of where the difference is between these cost initiatives are versus the $350 million of systems upgrades and things of that nature that you outlined in 2015.

Alain Karaoglan - *Voya Financial, Inc. - COO*

So, Michael, thank you. As we had mentioned, the strategic investment program of $350 million was expected to generate $30 million to $40 million of cost savings by 2018. We are expecting to generate at least $100 million by 2018, and in 2017 the expectation was around $20 million to $30 million and now it is $50 million to $60 million in 2017.

If you look at -- you know, what we are doing is really a continuation of our transformation journey since we went public. We had terrific franchises that were punching below their weight in terms of return on capital, and the reasons for that were cultural, not focusing on the right metric, and, as you know, we laid out a 400 basis-point return on equity improvement plan that we achieved two years ahead of schedule. Last year, we introduced, in 2015, that $350 million investment program that we expected to further simplify our infrastructure and technology, improve our digital analytics capabilities, and continue to break down the silos and working as one Voya firm.

We have made very good progress. We have learned through that, and that is allowing us to accelerate further some of our IT simplification in 2017 and 2018.

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As we mentioned, we're bringing our businesses closer together, and in particular Annuity and Individual Life insurance, and that's going to produce some meaningful synergies as well. So if you step back, it's really a continuation of our journey to continue to improve our unit cost, to provide an effortless experience to our customers, to improve our ROE, and to allow us to grow as fast as we can at these more attractive return on equity.

As we go through time, we will provide more detail on where the expense savings are coming from, which segment they may be affecting.

Michael Kovac - *Goldman Sachs - Analyst*

That's helpful. You have held the longer-term margin targets stable and gone through each of the individual segments with us. Can you help us think if there is any change in terms of the buckets as a result of potentially slower growth than you anticipated between -- I believe growth was really the primary driver of the improved ROC back in the 2015 Investor Day?

(technical difficulty)

Operator

Seth Weiss, Bank of America.

Seth Weiss - *BofA Merrill Lynch - Analyst*

Thanks for taking the question. I wanted to return to the statutory reserve changes and maybe start with just the policyholder behavior assumptions. And I understand the lower utilization offset lower surrenders in terms of the assumption review. Going forward, I believe you have a relatively large vintage of GMIB businesses that starts to reach its caps in the next three to four years in terms of the guaranteed benefits. How sensitive might reserves be if you start to see pickup in utilizations on these policies?

(technical difficulty)

Operator

Yaron Kinar, Deutsche Bank.

Yaron Kinar - *Deutsche Bank - Analyst*

Good morning, everybody. I think you may be having some technical issues, because we haven't heard answers to Mike's last question or to Seth's. But I will attempt to ask my questions anyway.

The first question relates to the ROE target, which remains unchanged. Maybe you can help me think through this. If I look at last quarter's call, I think at the time you talked about an 80 basis-point headwind from a 1% interest rate environment should it hold steady through 2019. We are clearly well above that today. And you are highlighting additional cost saves coming up. Why wouldn't the target move up from where it was?

(technical difficulty)

Operator

Pardon me, this is the operator. Again, please stand by. We are attempting to reestablish contact. Please stand by.

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(technical difficulty)

Again, please stand by. We are attempting to reestablish contact.

(technical difficulty)

Editor

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