Credit Opinion: Pacific Life Insurance Company

Pacific Life Insurance Company

Newport Beach, California, United States

Ratings

Category	**Moody's Rating**
Rating Outlook	NEG(m)
Insurance Financial Strength	A1
ST Insurance Financial Strength	P-1
Pacific LifeCorp	
Rating Outlook	NEG
Senior Unsecured	Baa1
Pacific Life & Annuity Company	
Rating Outlook	NEG
Insurance Financial Strength	A1
Pacific Life Funding, LLC	
Rating Outlook	NEG
Senior Unsecured	A1

Contacts

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Key Indicators

[1]
Pacific Life Insurance Company

	2008	**2007**	**2006**	**2005**	**2004**
Total Assets ($ Mil.)	$ 96,983	$ 111,024	$ 99,346	$ 87,115	$ 77,141
Equity ($ Mil.)	$ 4,088	$ 6,404	$ 6,097	$ 5,733	$ 5,450
Net Income ($ Mil.)	$ (289)	$ 647	$ 614	$ 542	$ 561
Revenues ($ Mil.)	$ 4,010	$ 5,049	$ 4,809	$ 4,259	$ 4,158
Equity % Total Assets	5.9%	5.6%	5.7%	5.8%	6.0%
Return on Equity (1 yr.)	-4.8%	10.9%	12.0%	11.3%	12.8%
Sharpe Ratio of Growth in Net Income (5 yr.)	NM			---	---
Financial Leverage	17.5%	16.4%	16.5%	16.5%	18.2%
Earnings Coverage (1 yr.)	-9.1x	11.1x	13.0x	14.3x	14.6x
Cashflow Coverage (1 yr.)	5.3x	5.7x	6.2x	7.0x	17.4x
High Risk Assets % Invested Assets	8.5%	9.0%	8.3%	8.7%	10.9%
Goodwill % Equity	0.7%	0.7%	0.8%	1.5%	1.5%
Liquid Assets % Policyholder Reserves	65.9%	69.8%	70.6%	70.5%	91.3%

[1] Information based both on statutory/regulatory and GAAP financial statements

Opinion

SUMMARY RATING RATIONALE

Moody's A1 long-term insurance financial strength rating of Pacific Life Insurance Company (Pacific Life) and its subsidiary, Pacific Life & Annuity Company (PL&A), and the Baa1 senior debt rating of its parent Pacific LifeCorp, are based on the companies' strong market position in the high end life insurance market, excellent financial leverage, broad product distribution and good profitability. Pacific Life's good business profile includes established market positions in variable and universal life, annuities, and group pension and institutional products. Pacific Life's P-1 short-term insurance financial strength rating is based on the company's excellent liquidity, careful liability management and access to alternative funding sources if necessary.

The company's strengths are somewhat offset by risks arising from the variable annuity business' sensitivity to equity market fluctuations, and credit exposures and already incurred and potential for future investment losses in the investment portfolio, especially in residential and commercial mortgage related investments.

In 2007, Pacific LifeCorp expanded its aircraft leasing operations (Aviation Capital Group) through the acquisition of a competitive lessor. Aviation Capital has remained consistently profitable through difficult times for the airline industry and continues to deliver strong results even in the current challenging environment.

PL&A's A1 IFS rating is based on the commonality of the operations of this subsidiary with its parent, Pacific Life: shared name, products, management and distribution among other key factors.

Credit Strengths

Pacific Life's credit strengths include:

- Established market positions in variable and universal life, institutional investment management and variable annuities

- Broad and balanced distribution

- Modest financial leverage

- Strong asset management capabilities

Credit Challenges

Pacific Life's credit challenges include:

- High degree of sensitivity of revenue, earnings, stockholder's equity and regulatory capital to equity market movements

- Guarantees on variable annuities that are challenging to hedge both on a statutory and GAAP reporting basis concurrently and consistently because of different accounting methods used for the underlying liabilities and uncertainties regarding policyholder behaviors

- Significant exposure to structured RMBS that, in many cases, have been subject to significant downgrades, and the potential for incurring substantial credit losses in these and other fixed income investments due to the recession

- Interest rate, liquidity and credit risks related to institutional investment products, heightened by significant unrealized losses in the company's fixed investment portfolio

- Strong competition in core affluent business and professional life insurance markets

Rating Outlook

On June 11, 2009, Moody's downgraded the long-term ratings of Pacific Life and maintained the negative rating outlook. The downgrade and negative outlook were based on the impact - and likely continuation in 2009 - of reduced and volatile capital levels, weakened coverage ratios and financial flexibility, as well as continuing investment losses.

What Could Change the Rating - Up

Since the rating has a negative outlook, a rating upgrade is unlikely; however, the rating outlook could be returned to stable if the following occurred:

- NAIC company action level RBC remains at or above 350%

- Financial leverage remains below 30%

- Investment losses are less than $500 million pre-tax in 2009.

What Could Change the Rating - Down

Factors that could cause Pacific Life's ratings to be lowered include:

- NAIC company action level RBC falls below 325%

- Financial leverage exceeds 30%

- Investment losses exceed $750 million pre-tax in 2009.

Notching Considerations

The spread between Pacific LifeCorp's senior debt rating and the IFS ratings of Pacific Life is three notches, consistent with Moody's typical notching spread for U.S. insurance holding company structures. Pacific Life also has a surplus note outstanding with a rating of A3, which is consistent with Moody's standard practice of notching life insurer's surplus note ratings two notches below the insurance financial strength rating of the insurer issuing the surplus note.

Recent Results and Company Events

Pacific Life's GAAP net income during 2009Q1 was $52 million, down from $119 million reported during the comparable 2008 period. The decline was primarily due to higher levels of credit impairments taken in 2009Q1 compared to those taken in 2008Q1. Pacific Life's statutory net income in 2009Q1 was $(37) million versus $228 million in 2008Q1, primarily due to increased investment losses taken in 2009. Statutory capital declined from $3.5 billion to $3.2 billion during 2009Q1, primarily due to a reduction in the deferred tax asset that Pacific Life is permitted to carry on its books.

Pacific Life had a 2008 GAAP net loss of $339 million, versus 2007 net income of $599 million. The decrease was driven by falling equity markets, reducing Pacific Life's revenues and increasing product guarantee reserves, and substantial credit losses from fixed income investments. Pacific Life had a statutory net loss in 2008 of $1.5 billion, versus net income of $362 million in 2007. However, most of the decline was associated with hedges of variable annuity guarantees that are reflected in capital, but are not reported in net income until they are realized, while the variable annuity liability guarantee costs are reported in net income immediately. Most of the remainder of the decline was due to the same reasons that GAAP income declined during the period.

Stockholders' equity of Pacific Life was $4.1 billion as of March 31, 2009, up from $4.0 billion at December 31, 2008.

DETAILED RATING CONSIDERATIONS

Moody's rates Pacific Life A1 for insurance financial strength, which is in line with the rating indicated by the Moody's insurance financial strength adjusted rating scorecard.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Factor 1 - Market Position and Brand: Aa

With the company having leading market shares in both the individual life insurance and variable annuity segments, Moody's views Pacific Life's market position and brand as being excellent. Pacific Life's market position is especially strong in the universal life and variable universal life insurance segments. As of December 31, 2008, Pacific Life was the 14th largest U.S life insurance company ranked by assets and was the 4th largest organized as a mutual or mutual holding company.

Factor 2 - Distribution: A

Pacific Life relies primarily upon a wide variety of third-parties such as independent agents, financial advisors, banks and registered representatives for its life insurance product distribution. As a result, Pacific Life maintains less direct control over its distribution and could see relatively lower persistency and more volatile sales for its third-party sold products than those companies that have more control over their distribution systems. However, Pacific Life's long standing relationships with key distributors, strong market position, reputation for excellent customer service, and breadth of distribution help somewhat offset our concerns. Overall, Moody's views Pacific Life's distribution as consistent with A-rated insurance companies.

Factor 3 - Product Focus and Diversification: A

The three primary insurance related products that Pacific Life distributes are life insurance (both fixed and variable), variable annuities and a variety of institutional investment products, such as funding agreement backed notes. Pacific Life is a leading insurer serving the high net-worth life insurance market and is also a leading variable annuity producer. Virtually all of Pacific Life's life insurance business is of the non-participating variety. Pacific Life continues to expand its product offerings over time. Moody's views Pacific Life's product focus and diversification as consistent with an A rating.

Factor 4 - Asset Quality: A

Pacific Life's general account investment portfolio consists primarily of fixed-income securities and commercial mortgages. Moody's considers 9% of the portfolio invested in higher risk items, more than half of which were the results of downgrades, primarily in the RMBS sector. The portfolio is generally well diversified by issuer and sector.

Pacific Life incurred $98 million in investment losses on fixed maturity investments during 2009Q1 (excluding derivative related gains and losses associated with the company's VA business), versus $26 million in investment gains reported 2008Q1. Virtually all of the 2009 losses were from impairments taken on structured investments.

Pacific Life reported $454 million in other-than-temporary fixed income impairments in 2008, a substantial percentage of which were subsequently reversed in 2009Q1 when Pacific Life early adopted new FASB accounting standard (FTP 115-2) that changed the reporting for this issue. These impairments were primarily associated with investments in Alt-A related RMBS, certain structured securities and securities issued by financial institutions.

The difference between the carrying value and fair value of Pacific Life's fixed maturity investment portfolio was approximately $2.8 billion at March 31, 2009, almost unchanged from that as of December 31, 2008.

Moody's expects that the company will realize meaningful additional losses and impairments in the investment portfolio, especially related to the residential mortgage-backed securities supported by collateral originated during the 2006 and 2007 time periods. Other possible areas of future investment stress include commercial mortgages (that are heavily concentrated in hotels, resorts and golf courses and include constructions loans on high end apartments), commercial mortgage-backed securities and non-investment grade bonds. Historically wide credit spreads have resulted in a large increase in Pacific Life's unrealized loss position, and realized losses and credit related impairments have lowered reported net income. As a result of the concern about the combined impact of past and potential future credit losses, Moody's has lowered the rating for the asset quality factor to A from Aaa.

Factor 5 - Capital Adequacy: Aa

Pacific Life has a weak capital adequacy ratio, as measured by its equity as a percentage of total assets of 5.9% as of year-end 2008, which is in line with Moody's expectation for a Baa-rated company. However, for U.S. firms we consider the NAIC risk-based capital (RBC) metric to be a more reliable measure of a U.S. insurer's capital adequacy. Pacific Life's NAIC RBC was 566% of its company action level as of year-end 2008, which is consistent with our expectation for life insurers rated Aaa, but down substantially from the 779% reported at year-end 2007. Total Adjusted Capital of Pacific Life was $3.2 billion at March 31, 2009 down from $3.5 billion at year end.

Moody's expect the company's RBC ratio will continue to be pressured in 2009 in large part due to increased capital requirements for investment holdings that have been downgraded. While Pacific Life has in the past maintained its RBC based capital adequacy at very high levels, this measure has become and is expected to remain volatile as the result of the guarantees associated with the company's variable annuity business. The ability of Pacific Life to stabilize both its reported nominal and risk-based capital levels will be a major factor in the company's ability to maintain an overall A1 rating. We believe that Pacific Life is now best positioned at a low end of Aa on this factor.

Factor 6 - Profitability: A

Moody's considers Pacific Life's profitability to be good. However, the earnings pattern has also been more volatile than we would expect from an A rated company. This volatility is primarily due to the sensitivity of earnings to equity market fluctuations, from the impact of reserve changes related to product guarantees and fluctuations in earned product fees on assets under management within the Annuities & Mutual Funds (AMF) Division. In 2008, AMF lost $279 million on a GAAP basis, versus reported net income of $282 million in 2007.

Pacific Life has addressed AMF's sensitivity to equity market fluctuations through several coordinated efforts such as a hedging program, customer asset diversification requirements, and reinsurance, and a more balanced level of sales between variable and fixed annuities. Some of these efforts were further expanded in late 2008 and again in early 2009. In Moody's view, AMF's earnings will continue to be challenged near term absent a sustained improvement in equity markets from current market levels, and this will negatively impact the company's overall reported profitability.

In addition, the profitability of the Investment Management Division (IMD) is sensitive to investment results. In 2008, IMD lost $181 million, versus net income of $53 million in 2007. We believe it unlikely that IMD will record a meaningful profit in 2009 given the level of investment losses reported in 1Q2009 by the division.

Overall, we believe that Pacific Life's profitability is in line with an A-rated company, so we have not adjusted the raw scorecard factor on this metric.

Factor 7 - Liquidity and Asset/Liability Management (ALM): A

Moody's believes that Pacific Life has excellent liquidity to meet its near-term policyholder obligations, and this is supported by a stable liability profile (excluding variable annuity guarantees). Moody's does have some liquidity concerns about the institutional products (IIP) sold by Pacific Life, but none of these products outstanding contain put options or other factors that make them especially challenging to match fund. Pacific Life also maintains a membership in the Federal Home Loan Bank system, which can supply liquidity when needed if the company has available additional unpledged collateral. Pacific Life is also has a commercial paper program that it can access if short-term funds are needed on a temporary basis.

Appropriately offsetting the risks assumed from a book of variable annuities containing embedded guarantees is a challenging task at best and is subject to model errors, difficulty in estimating clients' behavior and market disruptions. We have consequently lowered Pacific Life's rating on this factor to A from the Aa raw scorecard rating due to these challenges.

Factor 8 - Financial Flexibility: A

Pacific Life's adjusted financial leverage (18% at December 31, 2008) was at the Aaa level. Cash flow coverage in 2008 at 5.3x is in the Aaa range. Earnings coverage in 2008 is not meaningful since the company reported a loss in 2008. We believe that Pacific Life will be unlikely to reach its previous levels on the earnings coverage metric given the ongoing effects of lower equity markets on the company's revenues and earnings in addition to ongoing investment related losses.

Financial leverage is expected to move upward during 2009, and weaken financial flexibility, if the company issues additional debt to strengthen its statutory capital position. It is our expectation that over the long run earnings coverage should be in the A range of 4x to 8x. Cash flow coverage should be in the 3x to 5x range longer term, but is not expected to reach that level in 2009 due to difficult market conditions. Management has indicated that it does not intend to access the equity markets in the foreseeable future unlike some other major variable annuity writers that have recently accessed equity markets. Overall, we believe that Pacific Life's is best positioned in the A range for financial flexibility given the considerable challenges the company is facing in the current economic environment and its lack of access to the equity markets to recapitalize in the event of further losses in capital.

Rating Factors

[1]
Pacific Life Insurance Company

Financial Strength Rating Scorecard	**Aaa**	**Aa**	**A**	**Baa**	**< Baa**	[2]**Score**	**Adjusted Score**
Business Profile						**A**	**A**
Market Position and Brand (15%)						**A**	**Aa**
Market Share Ratio				**X**			
Relative Market Share Ratio			**X**				
Distribution (10%)						**A**	**A**
Distribution Control			**X**				
Diversity of Distribution			**X**				
Product Focus and Diversification (15%)						**A**	**A**
Product Risk			**X**				
Life Insurance Product Diversification			**X**				
Financial Profile						**A**	**A**
Asset Quality (5%)						**Aaa**	**A**
High Risk Assets % Invested Assets	**8.5%**						

Goodwill % Equity	**0.7%**						
Capital Adequacy (10%)						**Baa**	**Aa**
Equity % Total Assets				**5.9%**			
Profitability (15%)						**Baa**	**A**
Return on Equity (5 yr. avg.)			**8.4%**				
Sharpe Ratio of Growth in Net Income (5 yr.)					**-1.0%**		
Liquid and Asset/Liability Management (10%)						**Aa**	**A**
Liquid Assets % Policyholder Reserves		**65.9%**					
Financial Flexibility (20%)						**Aa**	**A**
Financial Leverage	**17.5%**						
Earnings Coverage (5 yr. avg.)		**8.8x**					
Cashflow Coverage (5 yr. avg.)	**8.3x**						
Aggregate Profile						**A1**	**A1**

[1] Information based both on statutory/regulatory and GAAP financial statements [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis