Moody's Investors Service

Credit Opinion: Pacific Life Insurance Company

Global Credit Research - 10 Feb 2010

Nebraska, United States

Ratings

Category	Moody's Rating
Rating Outlook	STA
Insurance Financial Strength	A1
ST Insurance Financial Strength	P-1
Surplus Notes	A3
Commercial Paper	P-1
Pacific LifeCorp	
Rating Outlook	STA
Senior Unsecured	Baa1
Pacific Life & Annuity Company	
Rating Outlook	STA
Insurance Financial Strength	A1
Pacific Life Funding, LLC	
Rating Outlook	STA
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, and annuities. 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 (VA) business' sensitivity to equity market fluctuations, and exposure to credit losses in the investment portfolio, especially in residential mortgage backed securities and commercial mortgage loans, which typically occur with a reporting lag.

Aviation Capital Group, its aircraft leasing subsidiary has remained consistently profitable through difficult times for the airline industry and continues to deliver favorable 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:

- Strong capitalization

- Established market positions in variable and universal life and VAs

- Broad and balanced independent distribution

Credit Challenges

Pacific Life's credit challenges include:

- High degree of sensitivity of regulatory capital, earnings, asset-based revenue, and GAAP equity to equity market movements

- Guarantees on VAs that are challenging to hedge

- Significant portfolio investment exposure to residential mortgage-backed securities (RMBS) that have been subject to significant downgrades, and the potential for incurring credit losses in other fixed income investments and commercial mortgage loans

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

Rating Outlook

The outlook on Pacific Life ratings was changed to stable from negative on February 5, 2010 primarily due to: (1) significant increases in the company's statutory capital base from contributions to the operating company from several capital raises, sufficient to manage a downside scenario; (2) expanded hedging programs to better manage the company's VA related equity risk; and (3) expectations that 2010 investment credit losses should subside from the highly elevated levels of 2008-09.

What Could Change the Rating - Up

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

- Capital and earnings sensitivity to market movements is largely eliminated

- GAAP return on equity is sustained above 10%

- Financial leverage (debt to capital) is maintained below 20% and earnings coverage is consistently above 8x.

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 2010.

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 surplus notes 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

The company's GAAP net income for the nine months ending September 30, 2009 was $445 million, up from $340 million for the comparable 2008 period. The improvement was primarily a result of a $438 million (pre-DAC and pre-tax) increase in the positive mark-to-market of VA guarantee-related embedded derivatives, net of hedges and policy fees during the nine months ended (or ending) September 30, 2009, as compared to the comparable 2008 period. These gains were partially offset by investment related impairment charges on RMBS and other portfolio investments, plus higher derivative losses incurred in the corporate segment.

The company had approximately $108 billion in GAAP assets and $6.1 billion in total GAAP equity as of September 30, 2009.

Statutory capital at Pacific Life was $4.0 billion at September 30, 2009, up from $3.1 billion at December 31, 2008. The increase was primarily due to $1 billion in surplus notes issued by the company in June 2009.

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 VA 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 primary insurance related products that Pacific Life distributes are life insurance (both fixed and variable) and VAs. Pacific Life is a leading insurer serving the high net-worth life insurance market and is also a leading VA 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.

The company incurred $458 million of other than temporary impairments on fixed maturity investments in 2008 with an additional $188 million incurred during the first nine months of 2009. The majority of these impairments arose from investments in RMBS and collateralized debt obligations (CDO). The company expects to report approximately $58 million more in impairments of fixed maturity securities in 2009 Q4.

Moody's expects that Pacific Life is likely to start reporting in 2010 increasing losses from its portfolio of commercial mortgage loans and commercial mortgage-backed securities (CMBS). Pacific Life's commercial mortgage portfolio is heavily concentrated in hotels, resorts and golf courses and includes constructions loans on high end apartments making the company's portfolio atypical for a life insurer. While these portfolios have performed well to date, Moody's believes that these markets are subject to considerable economic stress in the current environment and an increased level of future credit losses is therefore likely.

As a result of Moody's 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 company action level 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% 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.

Moody's expects that Pacific Life's December 31, 2009 RBC ratio will be at least as high as it was at year end 2008. Pacific Life has taken several actions during 2009 to strengthen its capital position including issuing a $1 billion surplus note in June and the contribution by Pacific LifeCorp of Aviation Capital Group as a new subsidiary of Pacific Life. Pacific Life's 2009 RBC ratio is also expected to benefit substantially from several NAIC policy changes, most notably from a change in the computation of RMBS capital requirements, which will result in a marked decline in the capital requirements to support these investment holdings.

Pacific Life has substantially expanded its equity hedging program in an effort to better stabilize its reported statutory capital position even when equity markets have major moves. Moody's believes that Pacific Life's ability to stabilize its reported nominal and RBC capital metrics, even if equity markets exhibit major movements, will be a major factor in the company's ability to maintain an overall A1 rating. We believe that Pacific Life is best positioned in the Aa range on this factor given its high level of reported capital, mitigated by its high degree of sensitivity to equity markets.

Factor 6 - Profitability: A

Moody's considers Pacific Life's profitability to be good. However, the company's earnings have been more volatile than we expect from an A rated company. This volatility is primarily due to the Annuities & Mutual Funds (AMF) segment's equity market sensitivity. This sensitivity stems from both changes in the level of reserves required to support VA product guarantees and fluctuations in product related fees earned. The AMF segment's net income was $431 million for the first nine months of 2009 compared to a net loss of $279 million for all of 2008.

Pacific Life has been addressing AMF's sensitivity to equity market fluctuations through several coordinated efforts including: (1) an expanded hedging program that actively uses derivatives to offset some of the VA block's inherent equity market sensitivity; (2) increased customer asset diversification requirements and product redesigns that both reduce its equity market sensitivity; (3) reinsurance that transfers some of the equity market risk to third parties; and (4) a heavier emphasis on fixed annuities, which are not sensitive to equity market movements. Moody's believes that AMF's earnings will continue to be sensitive to equity market movements, but that these changes over time should reduce it from levels experienced during past market downturns. However, this reduced sensitivity comes at the cost of a reduced level of expected earnings as these efforts also reduce the business' expected profitability.

The Investment Management segment has also been sensitive to credit market losses and reported a net loss both for both 2008 and for the first nine months of 2009. This segment has now been deemphasized by Pacific Life and should consequently become a less important factor for the company going forward.

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 VA 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 VAs containing embedded guarantees is a challenging task at best and is subject to model errors, difficulty in predicting clients' behavior and market disruptions. We have consequently lowered Pacific Life's rating on this factor to A from the Aa raw scorecard score 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. With recent debt issues we expect it to increase substantially to approximately 28% on a proforma basis including the February 2010 senior note issue. This positions the company at the upper limit for debt at its current ratings. Cash flow coverage in 2008 was at 5.3x, which is in the Aaa range, and is expected to rise to approximately 7x for 2009. Earnings coverage in 2008 is not meaningful since the company reported a loss in 2008, but is expected to be approximately 6x in 2009, consistent with a A score.

Moody's expects 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, due to difficult market conditions. Given the company is organized in a mutual holding company structure, we do not consider raising external equity to be a realistic alternative for the company. Overall, we believe that Pacific Life's is best positioned in the A range for financial flexibility given its increasing leverage, reduced coverage ratios associated with lower levels of expected earnings, and lack of access to equity markets.

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