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Ratings

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Research Update:

Pacific Life Insurance Group Upgraded To 'AA-', Aviation Capital Group Upgraded To 'A-'; Outlook Stable

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Overview

- Pacific Life Group continues to improve its enterprise risk management (ERM) program, demonstrating strong equity, insurance, and credit risk controls; at the same time, we have revised our view of the company's capitalization to include both its nondomestic and captive reserve financing reinsurance subsidiaries.
- We have also revised our view of its ERM to adequate with strong risk controls and its consolidated financial risk profile to very strong. We subsequently raised our ratings on Pacific Life and its core insurance operations to 'AA-' from 'A+'.
- At the same time, we revised the group status of Aviation Capital Group to strategically important based on the level of commitment, support, and earnings diversification provided to Pacific Life Group, and raised both our stand-alone credit profile and issuer credit rating on the subsidiary to 'A-' from 'BBB-'.
- The stable outlook reflects the group's very strong market position within the ultra-affluent segment, revenue-stream diversification, extremely strong capital generation, and sound balance-sheet characteristics.

Rating Action

On July 11, 2016, S&P Global Ratings raised its long-term counterparty credit and financial strength ratings on Pacific Life Group's core operating subsidiaries to 'AA-' from 'A+'. At the same time, we raised our issuer credit rating on holding company Pacific LifeCorp to 'A-' from 'BBB+'. We also raised our issuer credit rating on subsidiary Aviation Capital Group Corp. (ACG; its aircraft leasing arm) to 'A-' from 'BBB-'. The outlook on Pacific LifeCorp, its core operating subsidiaries, and Aviation Capital Group remains stable.

Rationale

The upgrade of Pacific LifeCorp and its core operating subsidiaries reflects our view of the company's continued improvement and progression of its ERM framework. We now assess the group's consolidated ERM as adequate with strong risk controls because the company continues to invest heavily in its comprehensive capital modeling capabilities along with improving upon its robust credit, equity, and insurance risk controls vis-à-vis peers.

Historically, it was the company's overall lack of more robust equity and interest rate controls that caused the volatility in its generally accepted accounting principles (GAAP) earnings related to its legacy variable annuity (VA) with guaranteed living benefits portfolio. We believe that as Pacific Life becomes more of a global enterprise, focused on a diverse set of insurance and aircraft-leasing risk exposures, its success will depend on the continued strength within its set of risks and its ability to further evolve its ERM program. This will be particularly important since the group is starting to write additional pension risk transfer and longevity risk transactions.

The upgrade also reflects the improved transparency we have into its consolidated capital and earnings base. This includes its international reinsurance subsidiaries domiciled in the U.K. and Barbados, as well as its domestically domiciled captive reinsurance entities. This, in turn, has improved the overall representativeness of our modeling and the outcome of our consolidated capital analysis maintaining in excess of the 'AA' ratings level in our outlook.

Through year-end 2015, the company reported continued strength in its risk-based capital (RBC) ratio of 632%. This RBC ratio fell from the prior year due in part to increases in the company's required capital levels, partially offset by a roughly 8% increase in capital and surplus. Through this same period, the company reported GAAP adjusted EBIT of $992 million, growth year-over-year of 29%, and a return on equity (ROE) of 6.5%. Through year-end 2016, we expect margins to drop a bit as measured by adjusted EBIT mainly due to continuing low interest rates affecting investment income and the mark-to-market accounting volatility in its legacy VA block of business.

We revised our view of group status on ACG's group status to strategically important stemming from the company's back office, risk management, and equity alignment. This is further emphasized through its intent to grow this operating subsidiary further via a potential IPO of part of the company's equity base, albeit limited to a minority interest publicly. ACG currently accounts for about 20% of Pacific Life's GAAP equity base and contributes an average 15%-20% of total revenue and adjusted operating income. We view ACG as providing the group with consistent operating income that is not significantly affected by interest rate or equity market disruptions. If the company continues to invest in ACG, resulting in outsized portions of the company's earnings base, or if it publicly announces an outsized IPO of the subsidiary, we could re-revise our view of group status on the entity.

Outlook

The stable outlook on Pacific Life and its core insurance operating subsidiaries reflects our expectation that the group will continue to maintain its very strong competitive position within the highly affluent life and annuity market with a focus on superior customer service and low lapse and surrender rates. We anticipate this focus on service, coupled with pricing discipline, will result in a relative flattening of net premiums during the year to about $2.3 billion-$2.7 billion. We also expect ACG, in tandem with the company's fee-based product offering, to continue to add to the diversification of the overall earnings base with consolidated enterprise adjusted EBIT of $700 million-$1 billion, somewhat offset by volatility in both the interest rate and equity markets. We expect the company will also continue to maintain capitalization above the 'AA' level as measured by our RBC model coupled with financial leverage below 25% and EBITDA fixed-charge coverage consistently above 7.0x. We also anticipate Pacific Life will maintain strong ERM controls while maintaining its derisked product portfolio. We expect this program to remain focused on interest rate risks and effective hedging programming.

Downside scenario

We could lower our ratings on Pacific Life and its core insurance operating subsidiaries if, contrary to our expectations, operating performance as measured by adjusted EBIT, return on assets, or ROE were to deteriorate to significantly less than our expectations for a prolonged period beyond our two-year ratings horizon. This could be exacerbated by outsized investment losses or major margin deviation from plan on the company's legacy VA portfolio. We could also lower the ratings if the company were show investment losses or operating performance degradation that directly hurt its capital base in conjunction with our RBC model outcome, or if the company becomes increasingly aggressive in its financial policies, resulting in heightened financial leverage metrics above 35% with EBITDA fixed-charge coverage of less than 5.0x for a prolonged period.

Upside scenario

We could raise the ratings on Pacific Life and its core insurance operating subsidiaries if the company continues to build its capital and surplus organically, maintaining RBC above 750% and the 'AAA' level per our consolidated RBC model. This includes any prospective dividend activity and bolt-on acquisitions of about $400 million-$500 million with consistent declines in the legacy VA portfolio. We would also expect ROE to remain consistently above 8% per year, with financial leverage of less than 15% and EBITDA fixed-charge coverage above 10.0x.

Related Criteria And Research

- Treatment of U.S. Life Insurance Reserves And Reserve Financing Transactions, March 12, 2015
- Methodology For Assessing Capital Charges For U.S. RMBS And CMBS Securities Held By Insurance Companies , Aug. 29, 2014
- Group Rating Methodology, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Methodology for Linking Short-Term and Long-Term Ratings For Corporate, Insurance, and Sovereign Issuers , May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate

Entities And Insurers, Nov. 13, 2012
- Methodology For Assessing Capital Charges For Commercial Mortgage Loans Held By U.S. Insurance Companies, May 31, 2012
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

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Ratings Affirmed

Pacific Life Insurance Co.
 Counterparty Credit Rating
  Local Currency                        --/--/A-1+

Pacific Life Insurance Co.
 Commercial Paper                       A-1+

Upgraded
                                        To                  From
Pacific LifeCorp
 Counterparty Credit Rating
  Local Currency                        A-/Stable/--        BBB+/Stable/--

Pacific Life & Annuity Co.
Pacific Life Reinsurance Company II Ltd.
 Counterparty Credit Rating
 Financial Strength Rating
  Local Currency                        AA-/Stable/--       A+/Stable/--

Pacific Life Re Ltd.
Pacific Life Re (Australia) Pty Limited
Pacific Life Insurance Co.
 Financial Strength Rating
  Local Currency                        AA-/Stable/--       A+/Stable/--

Pacific Life Insurance Co.
 Financial Enhancement Rating
  Local Currency                        AA-/--/--           A+/--/--

Pacific LifeCorp
 Senior Unsecured                       A-                  BBB+

Aviation Capital Group Corp.
 Senior Unsecured                       A-                  BBB-

Pacific Life Funding LLC
 Senior Secured                         AA-                 A+
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Pacific Life Global Funding		
Senior Secured	AA-	A+
Pacific Life Insurance Co.		
Subordinated	A	A-

Upgraded; Outlook Action

	To	From
Aviation Capital Group Corp.		
Corporate Credit Rating	A-/Stable/--	BBB-/Positive/--

Upgraded; Ratings Affirmed

	To	From
Pacific Life Insurance Co.		
Counterparty Credit Rating		
Local Currency	AA-/Stable/A-1+	A+/Stable/A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column.