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# Genworth faces hardship in core businesses

by XIA Xinyao

Genworth Financial Inc. (Genworth), the US largest player in the long-term care (LTC) insurance sector, posted a USD 1.08bn loss in the last 12 months, compared to a loss of USD 1.24bn in 2014 and a profit of USD 560mn in 2013. In Q3, Genworth reported an EPS of USD 0.13, representing a YoY decline of 92%. The company's profitability has faced a significant decline this year with a net loss of USD 284mn in Q3.

The RMI-CRI 1-year Probability of Default (PD) for Genworth has increased from 200bps since the beginning of the year to 429bps in December, while the RMI-CRI Aggregate 1-year PD for the other 11 industry players, including AIG, Hartford Financial Services and Assurant, remained low at around 2bps during the same period. In tandem with the worsening PD, Genworth's market cap has declined by 58% so far this year, and its stock has been removed from the S&P 500 Index.

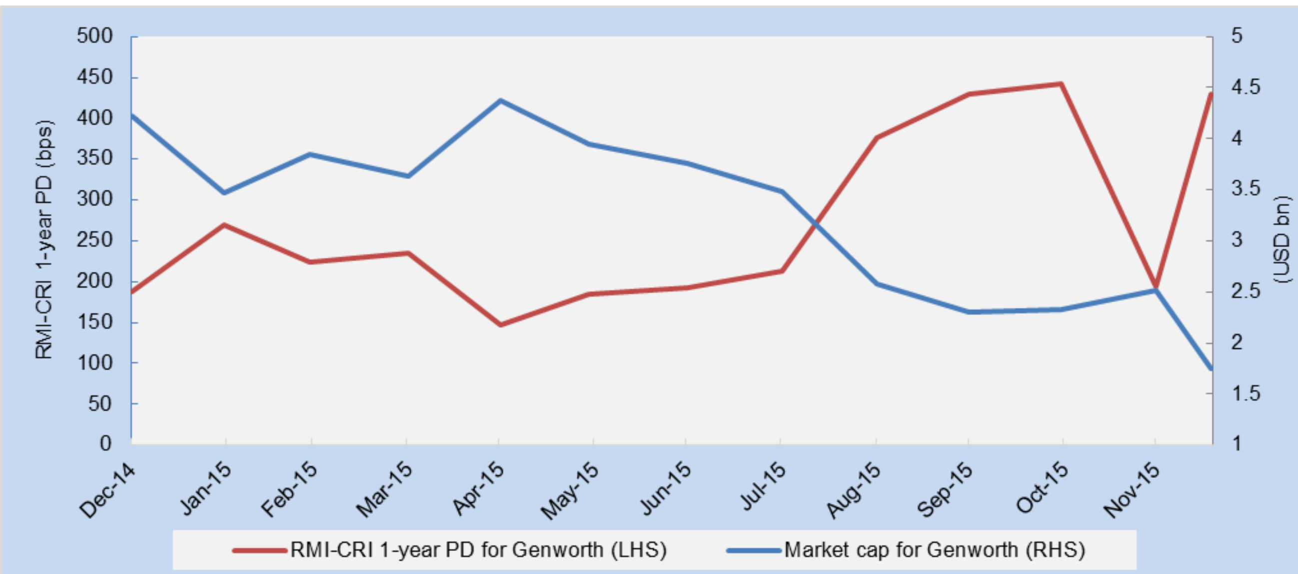


Figure 1: RMI-CRI 1-year PD and market cap for Genworth. *Source: RMI-CRI, Bloomberg*
Note: The decreasing implied asset volatility improved the RMI-CRI distance-to-default (DTD) in the PD calculation model and caused the PD drop in Nov 2015. Nonetheless, the DTD worsened due to market cap plunge in Dec 2015, elevating the PD back to the high level.

Genworth mainly operates in three divisions, namely life insurance, mortgage insurance, and corporate and runoff (see Figure 2 left panel). Revenue from the mortgage insurance division has decreased materially in the last 18 months. In Q3 2015, the mortgage insurance division's net income dropped 36% QoQ. The results deteriorated at its Canadian and Australian mortgage insurance units. Genworth Canadian's loss was due to a weak economy and drop in home prices which was aggravated by an unfavorable FX charge. The Australian subsidiary was negatively affected by a USD 6mn sell loss in May, lower tax benefits and an unfavorable FX charge.

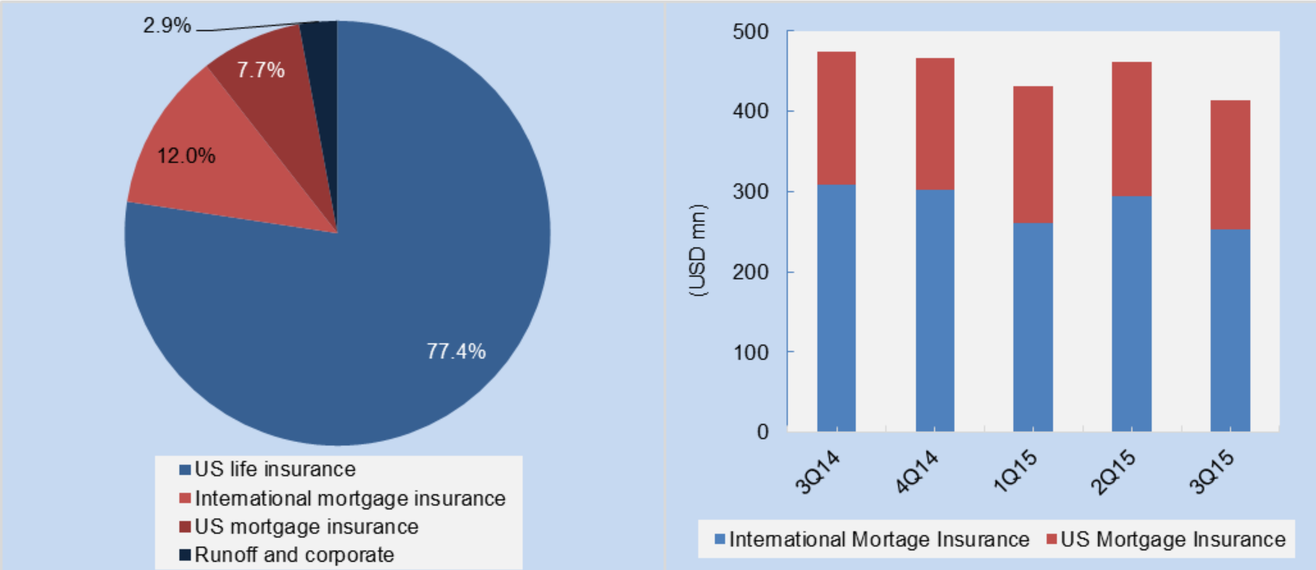


Figure 2: Revenue breakdown for Genworth by segment and mortgage insurance revenue. *Source: Bloomberg*

The life insurance segment in the US is the core business segment of Genworth, which accounts for around 80% of the company's total revenue in Q3 2015. Among all life insurance product lines, LTC products play a major role and account for 46.5% of the total revenue in Q3. LTC is a type of insurance that provides monthly payout used to offset the cost of hiring caregivers when the insured is unable to perform their daily routine tasks such as bathing and eating. However, underwriting LTC policies has turned into a black hole for Genworth. The operating climate for LTC insurance companies has been tough. Competitors like Metlife, Prudential and Allianz exited the LTC insurance sector between 2000 and 2012 due to economic uncertainty, unattractive rate margins and inaccurate actuarial assumptions which failed to foresee longer life expectancies and fewer policy lapses. According to the Table 1, Genworth's net operating income (NOI) of life insurance is in a declining trend. The LTC business even posted a loss of USD 10mn in the third quarter this year. In addition, this company disclosed a 'material weakness' in its internal control related to this unit, which highlighted financial reporting problems.

| | Q1 2015 | Q2 2015 | Q3 2015 |
|---|---|---|---|
| **Net income (USD mn)** | 154 | -193 | -284 |
| **US life insurance net operating income (NOI) (USD mn)** | 81 | 57 | 40 |
| **US LTC insurance NOI (USD mn)** | 10 | 10 | -10 |
| **Cost ratio (Life)* (%)** | 42.38 | 37.14 | 98.34 |

Table 1: Credit metrics of Genworth. *Source: Bloomberg*
*Cost ratio= Underwriting and policy acquisition costs / net premium earned *100

Genworth has taken steps to save the company by selling blocks of life contracts and buying back bonds in the public markets that trade at a substantial discount. They bought back USD 50mn in Q3 and said they may reduce the company's debt by USD 1-2bn over the next few years. The recent rate hike might work in favor for this life insurer, which earns substantial income from investing premiums, but it remains to be seen whether these strategies will work out in the long term.

**Credit News**

**Westfield sells five US malls for USD 1.1bn to cut gearing**

**Dec 21.** Westfield Corp has sold five shopping malls in the US for USD 1.1bn to reduce gearing and to fund a property development program. This sale, together with another transaction in November, would provide Westfield with about USD 1bn and reduce gearing, a measure of debt as a percentage of equity capital, by 3%. This move will also dilute funds from operations by 3.5 cents a security. Westfield will continue to hold a 20% interest in the five assets. The proceeds will also be used to fund the USD 11.4bn development program that is estimated to yield 7-8%. (Bloomberg)

**Real estate investors shed party mood**

**Dec 20.** With the slowdown in China's economy and geopolitical turmoil, risk appetite among global real estate investors has waned over the past years. This phenomenon was particularly strong among private equity funds, with less than half of them looking to increase their real estate risk, down from 81% based on last year. Although risk appetite has reduced, investors are demanding higher returns, with 69% of global investors looking to leverage returns of 11% or more, an increase from 59%, one year ago. These investors hope to achieve higher returns, through larger use of debt as the current cycle enters a debt-driven phase. (FT)

**Ukraine defaults on USD 3bn bond to Russia**

**Dec 18.** Ukraine has imposed a moratorium on the repayment of a USD 3bn bond to Russia. The bond, issued two years ago as part of a bail-out package under the previous Ukrainian prime minister, came due on Dec 20. The moratorium also applies to about half a billion dollars owed to Russian banks by two state-run companies. In response to the move, Russia announced that it would wait out a 10-day grace period, until the bond expires on Dec 30 before seeking legal action. (Bloomberg)

**Taiwan cuts key rate in Fed defiance as export slump deepens**

**Dec 17.** Taiwan cut its policy rate for a second straight quarter, marking a divergence from the US, as the contraction in its exports show no signs of recovery. The central bank lowered the benchmark discount by another 12.5bps to 1.625%. Policy makers justified that an expanding negative output gap and mild inflation, as well as the downside risks of global economic outlook for their decision. Additionally, exports shrank by the most since 2009 last month, signaling the unlikely prospects of a recovery from a 10-month slump, as economic growth in the China economy slows. The economy also shrank for the first time in 6 years since last quarter, as domestic consumption slowed. (Bloomberg)

**Fed raises rates after seven years at zero, expects 'gradual' tightening path**

**Dec 16.** The Federal Reserve has declared its intention to end the seven-year almost zero interest rates by raising the benchmark rate, with further plans to gradually lift it over the next three years. This move aims to test the economy's capability to continue spending and investment by households and businesses, with minimal central bank support. Investors in US reacted positively, with the Dow Jones Index surging after the announcement. Likewise, stock markets in Japan, Hong Kong, Australia and South Korea also moved higher, upon announcement. Additionally, the anticipation of higher rates and stronger growth in the US has driven investors to push up the value of the US dollar. However, this has negatively affected commodities prices and companies in emerging markets that aggressively borrowed during the low-rate period. The Fed's next decision to influence interest rate will be based on how inflation evolves. (WSJ)

**Hong Kong caught between US tightening and China slowdown** (FT)

**Hyundai set to miss sales target for first time since 2008** (Bloomberg)

**Toshiba likely to post USD 4bn net loss in current fiscal year** (WSJ)

**Regulatory Updates**

**Banks face tighter payout restraints as EBA urges change to law**

**Dec 19.** The European Banking Authority has clarified the calculation and trigger mechanism of the Maximum Distributable Amount (MDA), or the maximum payable amount of dividends, bonuses or hybrid coupons. According to the Capital Requirements Directive (CRD), EU banks that fail to meet capital adequacy requirements must calculate the MDA and are prohibited from 1) making a distribution in connection with Common Equity Tier 1 capital (CET1), 2) paying variable bonuses / discretionary pension benefits, and 3) making payments on Additional Tier 1 instruments. The MDA is calculated by multiplying the sum of interim year end profits not yet included in CET1, and a factor of 0, 0.2, 0.4 or 0.6 determined in accordance with Article 141(6) of the CRD. (Bloomberg)

**Banks' commercial real estate lending under fire from regulators**

**Dec 19.** US banking regulators are prepared to force changes to lending practices and establish tougher capital demands for firms that have lowered their standards in commercial real estates. After observing problems in rapidly growing loan portfolios, the regulators warned that banks with insufficient safeguards may be told to come up with plans for cleaning up their practices or raise extra capital to reduce their risk exposure. Banks that have undertaken expansion growth strategies or have seen significant growth in their commercial real estate lending will get the most scrutiny. Regulators increasing concerns stem from banks lowering their standard as competition has intensified over the origination of loans. (Bloomberg)

**China to stress test securities firms after stock-market slump**

**Dec 18.** A representative of the China Securities Regulatory Commission said that regulators will conduct stress tests on the country's financial institutions including brokers, asset managers and companies dealing in futures contracts. The tests will evaluate the firms' performance in financially adverse scenarios and improve their contingency plans in extreme market conditions. The CSRC believes that the stress tests will enhance supervision over the financial sector and improve the risk management practices in the industry. (Bloomberg)

**India introduces bill for bankruptcy law in parliament** (Business Times)

**Derivatives regulation spat nears Transatlantic détente** (FT)

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