General Electric Company (GE)

Global Credit Research GCRE013

FICC Research Dept.

Credit Issues (3): Can GE eliminate its exposure to insurance operations?

- $36bn of GAAP liabilities supported by $34bn of investment securities; the increase in insurance reserves require $11bn of annual statutory contributions over the next six years through 2024
- We believe it would be difficult for GE to eliminate its exposure to insurance operations given its size and complex structure; the most realistic scenario is for GE to keep its insurance business in run-off

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This is our third report in the series on GE's credit issues. In our first report we looked into GE's borrowings structure and GE's policy regarding leverage. We could confirm that GE has no liquidity issues in the short term due to its cash holdings and its rich credit facilities. However there is a concentration of debt maturities in 2020 that requires refinancing and/or raising cash by selling assets. In our second report, we looked into the underfunded pension liability and its impact on GE's cash outflows. We expect further contributions to the pension plans in the future given the large underfunded liability and the high amount of unrecognized net actuarial losses. However retained cash from the dividends cut should offset most of these contributions. For more details please refer to our previous reports:
"General Electric Company- Credit Issue 1: Concentration of debt maturities in 2020" released on December 14th, 2018
"General Electric Company (GE)- Credit Issues (2): Pensions" released on January 17th, 2019

In this report we will focus on GE Capital's insurance operations and their impact on GE's credit profile. On a GAAP accounting basis, liabilities related to insurance operations amounted to $38.1bn as December, 2017. These liabilities comprise $20.1bn of long-term care (LTC) insurance contracts and $18bn of structured annuities and other products (see the chart below).

Liabilities and assets related to insurance operations（GAAP accounting）

($m)	December 31, 2016	December 31, 2017	September 30, 2018
Long-term care insurance	**10,758**	**20,112**	**19,935**
Future policy benefit reserves	7,629	16,522	16,119
Claim Reserves	3,129	3,590	3,816
Structured annuities and other products	15,328	18,024	15,640
Total GAAP reserves	**26,086**	**38,136**	**35,575**
Investment securities	**44,180**	**38,231**	**33,961**

Source: Company materials; compiled by Daiwa.

LTC insurance contracts include both future policy benefit reserves (active life reserves) and claim reserves. Future policy benefit reserves represent the present value of future policy benefits less the present value of future net premiums. Claim reserves represent GE's estimate of ultimate obligations for reported and incurred-but-not-reported claims and the related estimated claim settlement expenses.

Future policy benefit reserves were first established based on actuarial assumptions at the time the policies were issued or acquired plus a margin for adverse deviation. These assumptions include interest rates, health care experience (including type and cost of care), morbidity, mortality, the length of time a policy will remain in force. Assumptions are locked-in throughout the life of a contract unless a premium deficiency develops at which time GE has to change these assumptions to reflect the most recent assumptions.

On January 16 2018, GE reported the results of a review of premium deficiency assumptions. With the completion of that review and of the annual premium deficiency test, GE recorded $9.5bn pretax charge ($6.2bn after-tax charge) to GE's earnings in the fourth quarter of 2017 mostly due to the increased expected future claim cost assumptions. On GAAP accounting basis, future policy benefit reserves related to LTC insurance operations increased 117% y/y in FY17 to $16.5bn and accounted for 82% of LTC insurance reserves.

Regarding the cash outflows related to insurance liabilities, it is important to understand that GAAP reserves and statuary reserves are different. It is statuary reserves (not GAAP reserves) that drive the capital funding requirements for insurance. In the first quarter of 2018, GE Capital made contributions of $3.5bn to its insurance subsidiaries. In addition, GE Capital expects to contribute approximately $11bn of capital through 2024 to its run-off insurance business subject to ongoing monitoring by the Kansas Insurance Department. The required contributions to the statuary reserve are expected to be made by GE Capital, which does not expect to make a common share dividend distribution to GE for the foreseeable future. GE is planning at least $3bn of capital contributions to GE Capital in 2019. GE may need to support GE Capital further in the future as GE Capital business is shrinking.

The premium deficiency testing is performed at least annually, usually in the fourth quarter and future adverse changes in the assumptions could result in an increase to future policy benefit reserves. 5% increase in future claim costs, holding all other assumptions constant, would result in a $1.5bn increase to future policy benefit reserves (GAAP accounting). 25bps decline in expected investment yield, holding all other assumptions constant, would result in a $1bn increase in future policy benefit reserves.

As of September 30, 2018, GE had $36bn of liabilities related to insurance operation which are supported by $34bn of investment securities. GE announced they are looking for options to mitigate or eliminate the exposure to its long term care insurance operations. We think eliminating the exposure would be difficult and too costly given the size of the insurance operations and its complex structure. The most realistic scenario would be for GE to live with its insurance operations as a run-off business. We will monitor closely the results of the insurance evaluation performed in Q4 2018.

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1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

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The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

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Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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[Fitch]

The Name of the Credit Rating Agencies group, etc

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The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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Assumptions, Significance and Limitations of Credit Ratings

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association