

June 2011



Pacific Life Insurance Co. Credit Summary Report

State of Domicile: Nebraska
Holding Company: None
Type: Mutual
Incorporated: 1868

Ratings as of: June 2011
Moody's: A1
S & P: A+
Fitch: A+

Pacific Life & Annuity Company and Pacific Life Insurance Company (Pac Life) are subsidiaries of intermediate stock holding company Pacific LifeCorp. The ultimate parent of these legal entities is Pacific Mutual Holding Company (Pac Mutual). The majority of the company remains under policyholder ownership, but the legal structure allows the parent holding company to tap the equity markets if necessary. Pacific Life Insurance Co, which transferred its legal domicile from California to Nebraska in 2005, is the 13th largest life insurance company in the U.S. and markets a full line of individual life and annuity, pension, and institutional investment products. Its much smaller subsidiary, Pacific Life & Annuity Co, focuses on writing variable universal life, variable annuities and guaranteed investment contracts. Credit ratings for Pacific Life and all related entities have remained stable over the past year.

PacLife utilizes a wide variety of third party distributors for its products, including independent agents, financial advisors and banks. As a result, the company has less direct control over its product distribution which could result in lower persistency and higher sales volatility than those insurers with more control over distribution. PacLife's long standing relationships with key distributors and a reputation for excellent customer service, increases its sustainability in the independent channels and somewhat mitigates these concerns. A substantial portion of Pacific Life's growth over the past decade has been through variable annuity and universal life product sales. Representing a historically significant proportion of earnings (~40%), these products have exposed the company to equity market volatility. PacLife has decided to discontinue certain VA guarantee riders and restructure product pricing due to higher costs and risks associated with guarantees and elevated credit losses in 2008 and 2009. Recently, the company has generated a more diversified revenue mix with significant sales of fixed annuities and mutual funds in its retirement business, and continues to show good growth in its universal life and variable life insurance products to high net worth customers where the company has a dominant market position.

Pacific Life reported FY10 net earnings of \$741mm on revenues of \$7.2b, compared to earnings of \$652mm on revenues of \$10.3b a year ago. Higher investment income and a moderation of investment losses helped boost the bottom line, but revenue growth was hindered by declining growth of annuity premiums and deposits. As of 1Q11, PacLife reported statutory net earnings of \$168mm on revenues of \$1.8b, compared to earnings of \$389mm on revenues of \$1.7b for the same quarter last year. On an operating basis, earnings of \$132mm were much lower than \$452mm reported at 1Q10. Solid growth in policy income was offset by higher underwriting expense, an increase in death and annuity benefits, and an increase in surrenders and withdrawals. Premiums and deposits rose 7.2% y/y, driven by strong sales of individual life insurance products and annuities, offsetting weaker group annuity demand. The reversal of the negative trend of declining individual annuity growth is significant because annuities comprise a significant portion of overall sales and earnings. PacLife has also taken the necessary steps to hedge or reinsure its equity related risk from variable annuities in order to reduce earnings volatility.

Investment income declined 13% y/y to \$394mm at 1Q11, primarily attributed to lower alternative investment income.

Improvement in the financial markets has contributed to positive valuation gains and fewer asset impairments, helping to preserve Pacific Life's strong statutory capital position. PacLife held \$43b of invested assets at 4Q10, primarily consisting of bonds (59%, 94% investment grade), mortgage loans (16%), policy loans (16%), and equities (4%). The company has significant exposure to CRE through CMBS (3%) and commercial mortgages (15%), but losses have been minimal. PacLife's commercial mortgage portfolio is concentrated in hotels, resorts, golf courses, and construction loans on luxury apartments, which is atypical for a life insurer. These mortgages have performed well to date, but the commercial real estate market is currently subject to considerable economic stress and an increase in credit losses in the near term is possible. PacLife also has exposure to RMBS (11%), with alt-A and subprime bonds comprising 3% of invested assets. PacLife reported \$113 in credit impairments during 2010, primarily attributed to RMBS investments, down from \$312mm last year. The company's net unrealized loss position at YE10 was \$48mm, a material improvement from net unrealized losses of \$1.1b during FY09.

At YE10 PacLife's total adjusted capital improved by 19.1% y/y to \$6.1b, driven by earnings growth, unrealized gains, and a \$450mm surplus note issuance during the year. The company's RBC ratio is robust at 618%, which is well above minimum expectations but tends to be subject to volatility in response to equity market movements. PacLife has substantially expanded its equity hedging program in an effort to better stabilize its regulatory capital position during equity market movements. Surplus notes as a percentage of total adjusted capital of 26% is high compared to the peer average, and somewhat dampens the quality of statutory capital. Liquidity is provided by \$1.3b of cash and ST investments, a \$400mm committed bank credit facility, a \$750mm credit facility at the parent company, and access to FHLB funding if needed, which adequately covers \$350mm in upcoming maturities of GICs and funding agreement backed notes.

As a result of the credit crisis and low interest rate environment, PacLife has re-focused its efforts on balancing its product portfolio between fixed and more simplified VA products and de-emphasizing certain institutional products, such as GICs and funding agreements. While the annuity business has been under pressure from elevated withdrawals and surrenders over the past several quarters, recent positive sales momentum is an encouraging indicator that the company's core product is still in high demand. Pacific Life remains a leading provider of life insurance and retirement solutions with a strong network of third party distributors. An influx of retirees in the near to mid term will bode well for fixed and variable annuity sales, which are popular products in the retirement and affluent markets that PacLife targets. PacLife could potentially incur moderate losses in its CRE-related investments, but mitigating this concern is the fact that the company has demonstrated its ability to restore regulatory capital through surplus issuance and parent contributions.

Pacific Life Insurance Co.

Strengths:

- Excellent capitalization and strong liquidity position
- Strong, established market positions in variable and universal life insurance and variable annuities
- Diverse and balanced independent distribution

Weaknesses:

- High degree of sensitivity of statutory capital, earnings, and asset-based revenue to equity market volatility
- Potential for significant credit losses from structured securities and commercial RE investments
- Strong competition in the core affluent and professional life insurance markets

Key Statistics - Pacific Life Insurance Company

(\$ millions)	2010	2009	2008	2007	2006	CAGR/Avg
General Account Assets	44,629	43,512	42,974	39,885	37,802	4.24%
Separate Account Assets	54,152	51,227	40,679	56,666	48,340	2.88%
Total Assets	98,781	94,739	83,653	96,551	86,142	3.48%
Capital & Surplus	5,867	5,006	3,136	3,708	3,218	16.20%
NET GFO	688	629	(1,240)	350	317	21.38%
Net Income	741	652	(1,529)	362	362	19.61%
Return on Assets (Stat.)	0.75%	0.69%	-1.83%	0.37%	0.42%	0.08%
Return on Capital (Stat.)	12.63%	13.02%	-48.76%	9.76%	11.25%	-0.42%
RBC Ratio (ACL)	1234.6%	1193.2%	1132.0%	1557.5%	1380.5%	1299.6%

Key Statistics – Pacific Life & Annuity Co.

(\$ millions)	2010	2009	2008	2007	2006	CAGR/Avg
General Account Assets	2,620	2,085	1,494	1,234	1,070	25.09%
Separate Account Assets	1,665	1,454	1,009	1,182	782	20.80%
Total Assets	4,285	3,539	2,503	2,416	1,852	23.33%
Capital & Surplus	424	371	288	369	365	3.82%
NET GFO	50	112	(106)	6	5	77.83%
Net Income	50	118	(116)	2	6	69.90%
Return on Assets (Stat.)	1.17%	3.33%	-4.63%	0.08%	0.32%	0.05%
Return on Capital (Stat.)	11.79%	31.81%	-40.28%	0.54%	1.64%	1.10%
RBC Ratio (ACL)	1534.6%	1328.6%	1856.1%	2920.0%	3290.2%	2185.90%

Sources: Company Reports and SEC filings

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