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Q3 2018 American Equity Investment Life Holding Co Earnings Call

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PRESENTATION

Operator

Welcome to American Equity Investment Life Holding Company's third-quarter 2018 conference call. At this time for opening remarks and introductions I would like to turn the call over to Julie LaFollette, coordinator of Investor Relations.

Julie LaFollette ***American Equity Investment Life Holding Company - Investor Relations Coordinator***

Good morning and welcome to American Equity Investment Life Holding Company's conference call to discuss third-quarter 2018 earnings. Our earnings release and financial supplement can be found on our website at www.American--equity.com. Non-GAAP financial measures discussed on today's call and reconciliations of non-GAAP financial measures to the most comparable GAAP measures can be found in those documents.

Presenting on today's call are John Matovina, Chief Executive Officer; Ted Johnson, Chief Financial Officer; and Ron Grensteiner, President of American Equity Investment Life Holding Company.

Some of the comments made during this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act. There are a number of risks and uncertainties that could cause actual results to differ materially from those expressed or implied. Factors that could cause the actual results to differ materially are discussed in detail in our most recent filings with the SEC. An audio replay will be made available on our website shortly after today's call.

It is now my pleasure to introduce John Matovina.

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

Thank you, Julie. Good morning, everyone, and thank you for joining us this morning. Our core third-quarter financial results remain strong and continued the solid trend we saw in the first half of the year. Non-GAAP operating income for the quarter was $171 million or $1.87 per share. If you exclude the impact of actuarial assumption reviews, our operating income would have been $90 million or $0.99 per share.

Our ongoing investment realignment program had a modest impact on third-quarter results but should build over time. So as a reminder, the three key metrics that drive our financial performance are: growing our invested assets and policyholder funds under management; generating a high level of operating earnings on the growing asset base through investment spread; and minimizing impairment losses in our investment portfolio.

For the third quarter of 2018 we delivered 1.4% sequential growth and 6.3% trailing 12-month growth in policyholder funds under management on a trailing 12 months basis, generated a 14.8% non-GAAP operating return on average equity, that's excluding the impact of the actuarial assumption reviews. And then excluding interest rate related losses from the investment realignment program, our investment impairment losses, after the effects of deferred acquisition costs and income taxes, were just 0.4% of average equity.

The growth in policyholder funds under management for the quarter was driven by $1 billion of gross sales. That was a 13% sequential decrease, but a 14% year-over-year increase. The IncomeShield 10 guaranteed lifetime income product launched in March has been a success. And following up on that, in October we launched the AssetShield, a new accumulation product in the independent agent channel. And we also raised payouts on guaranteed income products. You will hear more about the sales environment and competition from Ron.

While a sequential increase in investment spread in the third quarter primarily reflected an increase of 2 basis points in the benefit from non-trendable investment income and over hedging, we also realized some benefit from the higher yield on our invested assets. We expect to realize additional benefit from the realignment of invested assets in future quarters.

The cost of options continued to increase in the quarter and we implemented additional renewal rate actions in early October to supplement the changes we made in March. Ted will have more details on investment spread in his remarks.

Substantially all of the realized losses on investments recognized in the third quarter were interest rate related losses on securities sold early in the fourth quarter as part of our program to opportunistically replace lower yielding securities with higher yielding securities. Our low level of investment impairment losses once again reflects our continuing commitment to a high quality investment portfolio.

I will be back at the end of the call for some closing remarks. Now I would like to turn it over to Ted for some additional comments on third-quarter financial results.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

Thank you, John. As we reported yesterday afternoon, we had non-GAAP operating income of $171 million or $1.87 per share for the third quarter of 2018 compared to non-GAAP operating income of $87 million or $0.96 per share for the third quarter of 2017.

Excluding actuarial assumption revisions and the loss on extinguishment of debt in the third quarter of 2017, operating income would have been $90 million or $0.99 per share for the third quarter of 2018, compared to $64 million or $0.70 per share for the third quarter of 2017.

Third-quarter 2018 operating income included a benefit of $81 million or $0.88 per share from revisions to actuarial assumptions. Third-quarter 2017 operating income included a net benefit of $34 million or $0.38 per share from revisions to actuarial assumptions.

On a pretax basis the third-quarter 2018 revisions reduced amortization of deferred policy acquisition costs and deferred sales inducements by $49 million, and decreased the liability for future payments under lifetime income benefit riders by $54 million, for a total increase in pretax operating income of $103 million.

The third-quarter 2018 unlocking of deferred policy acquisition costs and deferred sales inducement assumptions was primarily driven by higher than modeled account values and a decrease in lapse rate assumptions, which translate to increased projections of expected gross profits in future periods. These were partially offset by 5 to 10 basis point decreases in our projections for future investment spread.

Through 2019 we expect weighted-average spread to be roughly consistent with the adjusted spread reported in the third quarter and then grade back to an ultimate spread of 256 basis points by 2024.

The decrease in the liability for future payments under lifetime income benefit riders was also driven by greater than modeled account values. This benefit was partially offset by a reduction in the expected growth rate of account values given the reductions in caps, participation rates and crediting that we have implemented over the last 12 months.

Investment spread for the third quarter was 267 basis points, up 3 basis points from the second quarter of 2018 as a result of a 7 basis point increase in the average yield on invested assets compared to a 4 basis point increase in the cost of money. Trendable spread in the third quarter was 249 basis points compared to 248 basis points in the second quarter.

Average yield on invested assets was 454 in the third quarter compared to 447 in the second quarter. The increase in the average yield in the quarter reflected the benefit from non-trendable investment income items of 11 basis points compared to 10 basis points in the second quarter.

Yield in the second quarter included 7 basis points from fee income from bond transactions and prepayment income and 3 basis points from the acceleration of RMBS paydowns. The average yield on fixed income securities purchased and commercial mortgage loans funded in the third quarter was 497 compared to 477 and 443 in the second and first quarters of 2018. The yield on investments purchased or funded in October was 496.

As can be seen in this quarter's results, we have benefited from the deployment of money into asset classes not traditionally in our portfolio. We have continued the higher allocations to asset backed securities such as collateralized loan obligations, and continue to look at increasing allocations to commercial mortgage loans. We have not taken on any material increase in credit risk with this allocation strategy. NAIC 3 investments were 3% of fixed maturity securities at September 30 compared to 2.5% at the end of last year.

As we've mentioned on our last two quarterly calls, we are looking to improve our investment yield through the opportunistic replacement of lower yielding securities with higher yielding securities. In early October we sold $384 million in book value securities with an average yield of 3%.

Since we have declared our intent to make these sales, we recognized interest related other than temporary impairments of $12 million in the third quarter. These impairments should be recovered from a higher yield on securities acquired with the proceeds from the sales in less than two years.

Including the October transactions we have sold $2 billion of book value of lower yielding securities this year and reinvested the proceeds into higher yielding securities. We intend to continue to explore additional opportunities for portfolio realignment. However, we are uncertain if there will be any additional transactions in 2018.

The addition of CLOs and certain commercial mortgage loans to our portfolio has positioned us to have a portion of the portfolio benefit from increases in short-term interest rates. At September 30 we had $4 billion or 7.9% of our investment portfolio in floating-rate instruments.

Three-month LIBOR was fairly stable in the second and third quarters, limiting the incremental benefit from the floating-rate portfolio in the third quarter. However, the three-month LIBOR rate has increased since the end of the third quarter and we will benefit if this recent increase is sustained.

The aggregate cost of money for annuity liabilities was 187 basis points, up 4 basis points from the second quarter of 2018. The benefit from over-hedging index-linked interest obligations was 7 basis points in the third quarter compared to 6 basis points in the second quarter.

The 5 basis point increase in the cost of money, excluding over-hedging benefits, primarily reflects the escalation of option cost for certain index strategies in the last several quarters that is recognized in the cost of money ratably over the 12-month option period.

In March we began lowering caps for the monthly point-to-point index strategy and raising spreads for our volatility controlled index strategy on $11 billion of policyholder fund value. While these actions helped mitigate the escalation in the cost of options, we have not seen the 6 basis point decrease in the cost of options we had expected.

Given the continued pressure on option costs from higher interest rates and equity market volatility, we began reducing fixed rates and caps and participation rates on annual point-to-point and monthly average strategies on $35 billion of policyholder funds under management in early October. We expect these latest reductions to produce annual savings in the cost of money of nearly 7 basis points on the $35 billion and almost 5 basis points on our entire in-force once they are fully implemented over the next several quarters.

One trend affecting quarterly spread comparisons is a change in the product mix away from bonus products to non-bonus products, which include the American Equity Choice and AssetShield and Eagle Select products. Non-bonus products have a lower spread requirement but similar returns which -- to compare to produce products, which translates into a higher cost of money for non-bonus products. The estimated impact from this change on the third-quarter sequential spread outcome was modest at 1 basis point, similar to the impact in the second quarter.

We continue to have flexibility to reduce our crediting rates if necessary and could decrease our cost of money by approximately 65 basis points if we reduce current rates to guarantee minimums. This is up from 59 basis points at the end of June. Our estimated risk-based capital ratio at the end of September was 386, up from 378 at the end of last year.

Now I'll turn the call over to Ron to discuss sales, marketing and competition.

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

Thank you, Ted. Good morning, everyone. As we reported yesterday, gross sales for the third quarter of 2018 were $1 billion, a 13% sequential decrease compared to the second quarter of 2018, but a 14% increase from the third quarter of 2017. Fixed indexed annuity sales decreased 12% sequentially, reflecting a 13% decrease at American Equity Life and a 5% decrease at Eagle Life.

We again saw a number of competitors raising caps, participation rates, crediting rates and income. Our higher new money investment yields allowed us to take several actions late in the third quarter and early in the fourth quarter to enhance our competitiveness.

Reflecting the continued attractiveness of accumulation products, the Choice Series continued to be our best selling product line at American Equity Life with 35% of sales in the third quarter and Choice 10 remained our best-selling product. In September we increased S&P 500 participation rates on all Choice Series products. Choice 10 with an MVA now has an annual participation rate of 54%, up from 52% previously, which is very competitive.

We enhanced our competitive position in accumulation products with the introduction of the AssetShield series on October 9. While it's similar to the Choice Series, AssetShield is for pure accumulation and a lifetime income benefit rider is not available. AssetShield 10 has the same 54% annual participation rate on the S&P 500 as the Choice 10, plus it has an annual participation rate of 120% on the S&P 500 Dividend Aristocrats volatility controlled index strategy and a 175% participation rate on the same index strategy if a policyholder chooses a two-year strategy term.

Our participation rates on the Dividend Aristocrats are very competitive with the participation rates currently being offered by the J.P. Morgan Mozaic II Index and Nationwide New Heights, currently the best selling accumulation series in the independent channels, without requiring a three-year strategy term, an asset fee or linkage to a nontransparent complex multi-asset index. AssetShield also features better liquidity options than offered with the Choice.

Guaranteed lifetime income has been a significant focus for us through the years and we are thrilled with the acceptance of the IncomeShield series by our independent agents. IncomeShield was our second best-selling product line in the third quarter, accounting for 26% of American Equity Life sales.

We improved the competitive position of the IncomeShield and our other guaranteed income products by increasing payout factors on October 9. IncomeShield now ranks number one, two, or three in what we believe to be the most important aged deferral combinations.

Turning to pending, pending business at American Equity Life averaged 2,309 applications during the third quarter and was 2,224 at the end of September compared to 2,341 applications when we reported second-quarter 2018 earnings.

The introduction of the AssetShield and increase in payout factors for IncomeShield and our other guaranteed income products has already had a positive effect on sales. Pending applications stand at 2,547 as of this morning compared to 2,168 on October 9 when

AssetShield hit the market and payout factor increases became effective. One year ago pending was 2,178.

The number of submitted applications has been increasing as well. For the five weeks ending October 12, submitted apps at American Equity Life averaged 625 per week. We've received more than 700 applications in each of the three weeks following the October 9 product actions.

Our weekly submitted application count has not been above 700 since the week of May 14-18. Last week we received 795 submitted applications, and for the AssetShield and choice combined we received 322 applications, a record for us in the accumulation space. We also received 242 applications for IncomeShield, also a weekly record for that product.

The 5% sequential decline in Eagle Life's fixed indexed annuity sales reflects the hypercompetitive environment in the bank and broker dealer channels. Hurricane Michael may have had some effect as well as some of Eagle Life's -- since some of the Eagle Life's largest distribution relationships are based in the Southeast. Pending at Eagle Life stands at 326 applications today compared to 263 when we reported second-quarter earnings.

During the third quarter, Eagle Life added one of the 15 largest banks based on assets as a distributor. We have begun to see new applications from its representatives and expect this to be a key account for Eagle Life in 2019.

We are also in the process of hiring three additional employee wholesalers which will bring our total to six. These wholesalers will support some of our third-party wholesalers as well as build out our direct wholesale model as we gain approval in more financial institutions.

And with that I'll return the call back to John.

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

Thank you, Ted and Ron. We are pleased with our third-quarter operating earnings results. Higher new money investment yields combined with our investment realignment strategy should lead to a higher effective portfolio yield. Now, rising option costs do remain a challenge, but we continue to reduce rates in response and we have ample room to lower our caps, participation rates and crediting rates on our in-force business if necessary.

We took advantage of our higher new money investment yields to enhance our competitive position in the market. The improvements we made in AssetShield compared to Choice are significant and have been well received by our independent agent distribution. As of last Friday we had already received 335 AssetShield applications even though the product had been available for less than a month.

The increase in payout factors for IncomeShield is resonating as well. IncomeShield applications hit a new weekly record last week.

Before we move to question and answer I'd like to advise everyone that we will not be commenting on or answering any questions about market parameters or a potential transaction.

One constant in American Equity's 20-year history has been the extraordinary commitment and dedication to providing superior customer service our employees demonstrate each and every day. On behalf of the entire American Equity team, thank you for your time and attention this morning. We will now turn the call back to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Pablo Singzon, JPMorgan.

Pablo Singzon ***JPMorgan - Analyst***

My first question is how are you thinking about the trade-off between sales and profitability as you try to match competition in more attractive products? Are you still able to maintain your new business IRRs and how much of that are you willing to give up to stay competitive?

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

We are looking to maintain our IRRs on new business and the rate increases and the product changes have been facilitated by the higher investment yield. So that still is our philosophy; it has been for a long time to maintain discipline in our product pricing and achieve desired returns.

Pablo Singzon ***JPMorgan - Analyst***

Okay. And the second question is with the DOL rule vacated, can you talk about how your sales practices have changed, if at all, and if you've seen any changes at your competitors? So, I'm just wondering if there's any difference between you and others that might be affecting your competitive position aside from just the types of products you are selling. Thanks.

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

So when you talk about sales practices are you talking about incentives and those things that (multiple speakers)?

Pablo Singzon ***JPMorgan - Analyst***

Correct, correct, yes.

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

We have seen some since the DOL has been vacated from our competitors. We haven't taken any actions regarding that. Some of our competitors have announced some trips and there's been some incentives around sending in e-applications versus paper applications.

But as far as American Equity is concerned, we have our annual fall conference where we invite our top producers and we have a class a couple days while they are there, but that's kind of the landscape today.

Pablo Singzon ***JPMorgan - Analyst***

Okay, thank you.

Operator

Kenneth Lee, RBC Capital Markets.

Kenneth Lee ***RBC Capital Markets - Analyst***

Wondering -- just a follow-up on the competitive environment. Wonder if you could frame how competitive AEL's products are currently versus peers across the accumulation and the guaranteed income products.

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

When we look at income products, as I mentioned in my comments, we are number one, number two or number three in what we consider the sweet spot or the most important combinations of deferral and payout ages. If we compare it against say our top three competitors, Athene, Security Benefit and F&G, we are on average with the male rates about 104% of Athene's payout factors on average. Security Benefit and F&G, we are pretty much even with them in that sweet spot so to speak and with our female rates we are about 99% of Athene and 95% with both SBL and F&G.

On the accumulation side, we are also very competitive there. We're excited about the AssetShield where we can now talk about a 175% par rate on our Dividend Aristocrats which -- and that's on a two-year point-to-point which competes against Nationwide's three-year point-to-point at 180%, and they also have that spread to go along with it. So par rates, we're very competitive on par rates. Our highest is 54%; although we have seen some competitors in October come up with a 55% participation rate. So they are gunning for us so to speak.

Kenneth Lee ***RBC Capital Markets - Analyst***

Got you. And one follow-up and just in terms of the investment portfolio reallocation, you've repositioned about $2 billion of assets so far this year. Any thoughts on how much more assets you could expect to reposition? And maybe any kind of rough indication of expected improvement in terms of net investment income or portfolio yield from these efforts? Thanks.

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

I think looking at the investment portfolio we do have some opportunities to further enhance investment yield by doing some repositioning. A lot of that is going to be dependent on the timing of where interest rates are when we look to do that repositioning. But it's hard to give an exact dollar amount just based on what we see today, but we can let you know that we do have flexibility to add some additional yield through further repositioning.

Operator

John Barnidge, Sandler O'Neill.

John Barnidge ***Sandler O'Neill & Partners - Analyst***

How large in size do you see the top 15 bank that was added contributing? And should we expect quite a lot of MYGAs initially to get them on board?

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

The financial institution that we brought on board through the third quarter was about a $350 million account for fixed Annuities. That's what they reported. The business that we've received, we are in early stages; we received about $1.4 million in sales with about another $0.5 million pending.

So far the mix with that account has been two-thirds MYGA and a third FIA, which we are okay with. Because, as we've always talked about, we want to use the MYGA rates to try and get some enthusiasm and then convert to FIAs once we've established that relationship.

John Barnidge ***Sandler O'Neill & Partners - Analyst***

Okay and my follow-up question, operating expenses is showing quite a lot of discipline despite the increase in sales. Can you talk about where that's coming from? And also maybe in the vein of the three new employees you are citing, can you talk about maybe are you looking to do more digital direct to consumer? Thank you.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

Certainly the trend in operating expenses is different than maybe what we saw this quarter as obviously trended up over time as we continue to grow our policyholder funds under management. We certainly would expect that we'll continue to see some level of increase in our employment -- the number of employees we have just due to the growth of the Company.

We do have a variety of efforts that we have always been focusing on the efficiency of our operations and being able to do things in a more electronic format versus manual. And trying to -- I guess the phrase we use is meet our customers where they want to be met at in regards to how they want to transact with us.

I don't know that we have any firm numbers or anything around that to tell you what kind of cost savings that can or cannot drive or what we've seen. We've always been a very efficient operator and we've always said that that's always been driven around the fact that we've been a Company that's been grown from scratch from the very beginning on one administrative system.

And when you operate on one administrative system that allows you to have great efficiencies in regards to how you train and how you operate throughout the whole organization. I'll let -- Ron is closer to the operations than I am.

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

That's something that we are looking at really closely these days: what are some things we've been doing for a long time that we can -- you asked the question, why do you do it that way, and it's because I've always done it that way. And you take a look at it to see, well, can you do it better. And we are finding efficiencies just by looking.

One quick example is if somebody previously wanted to make a penalty free withdrawal we'd require reform. We'd send the form out, they'd come back and a third of them were not in good order, so we would have to make a call out and you'd have to try and talk to them and get the form. And then they'd send it in and they would then subsequently call wanting to know the status of their withdrawal. And there was a lot of back and forth and also a lot of time with that.

We made the decision if somebody calls in, as long as we can verify their identity and their address and all that, we can just take that request over the phone, as long as the withdrawal is within a certain limitation. That right there is a big time savings and we haven't had to make phone calls for those NIGOs and we've exceeded their expectations on delivering their penalty free withdrawal. So that's just one quick example of where we know we are going to pick up some efficiencies.

Operator

John Nadel, UBS.

John Nadel ***UBS - Analyst***

Hey, good morning. I have a question on risk-based capital and then a follow-up. Ted, if I think about RBC has been increasing here pretty consistently and steadily the last several quarters. I think the 3Q level was 386; that compares pretty favorably to your target of 375 or greater.

I'm just wondering as we get through the implementation of some formula changes, tax impacts this year, maybe some PT1 changes for next year, where do you stand currently in terms of your estimate for the impact of those adjustments? And as you've had conversations, I assume further conversations with the rating agencies, where is that shaking out in terms of an adjustment, if you will, to that 375 target?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

So I think our current estimate in regards to implementing the tax reform changes that would go into place, in looking at that at RBC we've reported 386. I think that would take it down to approximately 371 for that piece. I'm trying to -- maybe we can have somebody look -- do you have the other number for the --?

For the asset change factor we'd have to go back. We haven't refreshed that in a while in regards to that piece. Continued -- in regards to conversations with the rating agencies, again, they look at RBC, they look at RBC in regards to from a regulatory standpoint. But as I have said before, each one of them -- each rating agency has their own capital model and these changes that are being considered by the NAIC to be implemented for RBC don't necessarily affect their capital models.

So, I think it's just going to be a resetting of the targets. And obviously I think it's not necessarily going to turn be that you need to build that capital back up to replace the decrease you're going to see in your RBC.

John Nadel ***UBS - Analyst***

Got you, that's very helpful. And then my follow-up. John, I appreciate and I do respect your comment that you don't want to address market rumors, but you all chose a little over five months ago to address those rumors with a press release that indicated that the Company was evaluating a transaction.

So, that is no longer a market rumor; that's your Company making an affirmative statement. Given you're not that complicated, after five months can you at least tell us whether that original proposal is even still on the table or has it been withdrawn?

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

The statement we made was that we would not be making any further comments and that statement is true today. When we have a comment to make we will do so.

John Nadel ***UBS - Analyst***

Okay, guess we will leave it at that. Thank you.

Operator

Randy Binner, B. Riley FBR.

Randy Binner ***B. Riley FBR - Analyst***

So, I have a question about -- I think you said there are 65 basis points of cumulative or all in repricing potential in the book. Can you remind us of the dynamic that made that number bigger than it used to be? I think I recall it being kind of high 40s, low 50 basis points.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

So Randy, as we add new business, that new business is going out at rates that are above the minimum guarantee, and so that could expand it up. And certainly as we make rate adjustments, though, that will bring it back down. Some of the product we are issuing right now has a bigger spread between minimum guarantees and the current rates it's going out than maybe some of the mix of business we've historically sold, so that's what's driving it up.

But certainly remember, we've got some rate adjustments that we just started in October and that's going to start too. And you still have the rate adjustment, some of it from March. Some of that is still flowing through too that will bring that number down.

Randy Binner ***B. Riley FBR - Analyst***

Okay, so it will land like at 60?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

I don't have a projection for that for you right here. It kind of depends on -- I mean I can sit and try to calculate out what I think it would come down on the in-force block we have, but then it always depends on what's the mix of business and how much sales do we put on.

Randy Binner ***B. Riley FBR - Analyst***

Okay. And then on new money yield, I think you said 496 overall for the -- for bonds.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

For October purchases.

Randy Binner ***B. Riley FBR - Analyst***

Yes.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

Correct.

Randy Binner ***B. Riley FBR - Analyst***

What is the -- so I wanted to confirm that and then like on the CLOs -- I guess since the NAIC weightings are similar for these increase in structure activity, what kind of spread enhancement are you getting on structured securities, assuming that the credit weighting is the same?

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

Looking at -- are you implying like a single A corporate credit versus a single A rated CLO?

Randy Binner ***B. Riley FBR - Analyst***

Yes, yes.

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

You are getting 50-plus basis points of additional yield at least.

Randy Binner ***B. Riley FBR - Analyst***

Okay. How sustainable is that and how liquid is that market opportunity?

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

You are giving up some liquidity going to a CLO, but we have plenty of liquidity in the portfolio. That has never been an issue for us with the size of -- with an A- average credit quality portfolio with a large portion in corporate credit. For us it's a way that we are just realigning and redistributing risk in the portfolio.

When you look at cyclical downturn CLOs in the last cycles have held up better than corporate credits of equal credit quality. And for us, as we are getting late in the cycle, it's one more way that we can mitigate potential corporate credit exposure risk that we might have in the portfolio.

And for us it also creates a floating-rate asset and it's giving us more yield. And it's a security that can also reset to higher yields as rates go up to help keep us more competitive on renewal rates. So it's kind of a win-win as we look at this. And it's a very attractive opportunity for us. We had very little to low exposure two years ago and the increase in that exposure has helped us and will continue to help us as we go forward.

Randy Binner ***B. Riley FBR - Analyst***

Just back to the 49 --- that's helpful. And the 496, what's the blended rating of that, the 496?

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

BBB+, A-.

Randy Binner ***B. Riley FBR - Analyst***

All right, thank you.

Operator

Alex Scott, Goldman Sachs.

Alex Scott ***Goldman Sachs - Analyst***

First question I had was on the crediting and rate actions that you've planned. I guess is most of that still on surrender? Would you expect any pickup in lapses? And how should we think about lapses as we look out over the next year?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

I don't think we are necessarily expecting an uptick in lapses from the current rate adjustments that we are implementing. I think those policies that we are still adjusting are still marginally or above what current products are being offered at. Certainly we saw a very slight uptick in surrenders this quarter.

We would expect as interest rates continue to go up that we would see an uptick in surrenders, but yet our surrender rate that we are experiencing is still below what we had modeled. And we continue to push that out as part of our assumption review and have it grade back up to what our original surrender assumptions were on the products, expecting that surrenders will increase as interest rates increase over time.

Alex Scott ***Goldman Sachs - Analyst***

All right, that's helpful. And then just high level on spreads, it seems like there's a lot being done on the asset side, reallocation and higher new money yields, a little bit of shift in the way you guys are allocating investments and it's really benefiting NII. But spreads really like on an adjusted basis only really went up I guess about a basis point, maybe 2 depending on how you adjust last quarter.

With costs of money increasing, I guess netted with your action you're taking on the crediting rates, are you expecting that spreads will be able to just sort of hold then where they are, will they improve? Are you expecting pressure? Just any color would be great.

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

I think the expectation over time is, yes, that spreads will go up. The cost of money obviously could continue to go up, but there's been I think a little bit of stabilization of the costs. Obviously higher interest rates can translate into further increases in cost, but that should be masked by increases in investment yields as well.

Alex Scott ***Goldman Sachs - Analyst***

All right and maybe one more if I could. I know you guys don't want to talk about the possibility of a transaction. I guess my question is really about how having that out there has impacted the fundamentals of the business if at all. Are you seeing any kind of impact, whether it's distributors or from consumers, associated with the potential for a transaction out there?

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

I think the only thing we can say is anecdotally agents make comments to us that suggest it's impacting their activities, but we have no concrete evidence that it is impacting sales. But as I say, anecdotal evidence.

But just like sales history through the years, it's always a big question to explain exactly why did sales happen the way they did. You get indications -- anecdotal; you obviously can compare rates and terms, point to that. But if the situation is really influencing agents, we have no way of really knowing that it is and how much.

Operator

Dan Bergman, Citi.

Dan Bergman ***Citigroup - Analyst***

One of your competitors had made some comments in recent months that they feel that reserves for guaranteed income riders are potentially not sufficient across the indexed annuity industry with a range of levels across peers. So I just wanted to see if you had any thoughts on this topic and views of your comfort level with rider reserve levels for AEL and/or I guess just the industry overall.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

There's a lot of differentiation among product across the industry so it's very difficult to really give any opinion across the whole industry or what maybe competitors are doing. What we've always talked about, first of all, is about 43% of our account value that has a lifetime income benefit rider is the no fee rider.

So obviously when we've talked about our assumptions and what we have there, we've said the main things that really affect lifetime income benefit reserve is utilization, lapsation and index credits.

In regards to utilization, if it's a fee rider we are assuming a 75% utilization rate and then we are assuming half of that if it's a no fee rider. Obviously account value growth and what that is going to be is always a driver of it, along with what lapses are going to be. If policyholders don't lapse at the rate you expect that could cause the reserve to go up. But at the same point in time there somewhat of an offset to that because your DAC is going to go up because you're going to have more expected gross profits than what you really assumed.

With all of this there's not -- what I can say is across the industry the product hasn't been out there that long. We've been issuing it since 2007. Our experience to date in regards to utilization is dramatically lower than what we would have estimated. And we have been issuing this product since 2007, and so we've got a fair amount of experience with it.

So, we will certainly -- as everybody will have to monitor what actual experience is, but to date our actual experience, compared to our assumptions, we think we are adequately reserved at this point in time.

Dan Bergman ***Citigroup - Analyst***

Got it, that's very helpful. Thank you. And then maybe just following up on the earlier question around new money yields. Based on the opportunities you're seeing in the market and your appetite level in various asset classes, do you think the around 5% new money rate you saw last quarter is sustainable if interest rates stay near current levels? Or alternatively, is there potential for further upside? Just a sense of how you're thinking about that would be helpful.

Jeff Lorenzen ***American Equity Investment Life Holding Company - CIO***

I think for the next quarter maybe two that might be sustainable. I think we go beyond that and some of the asset classes we've been under weighted in we'll be getting to the point where we are hitting our target levels and we'll need to be looking for other assets that would support the yield.

But I do think that high 4% is achievable on a sustainable basis. So, we have some other opportunities that we are looking at in terms of asset classes that could help support some higher yields above that. But at this point in time I can't comment on that because they are not in place and I don't want to give guidance that would be unjust.

Dan Bergman ***Citigroup - Analyst***

Got it, thanks so much.

Operator

Mark Hughes, SunTrust.

Mark Hughes ***SunTrust Robinson Humphrey - Analyst***

I wonder if you have a shorthand for what the impact of movements in the short-term rates might be for say your spread, overall investment yield if 8% of the portfolios is in the floating-rate instruments? How impactful is that 10 basis points to 20 basis points to your spread?

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

We're all looking at each other because we haven't done the math recently. But I think the way to think about that is -- is it $8 billion -- or what's the --?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

We have $4 billion.

John Matovina ***American Equity Investment Life Holding Company - Chairman, President & CEO***

$4 billion -- $4 billion, 8%. So just take that number, those floaters are pegged to three-month LIBOR which -- I guess if you think in terms of 25 basis points, do the math, that will be the increase in investment yield. But obviously then bottom line that will flow through investment spread or DAC calculations as well, so --.

Mark Hughes ***SunTrust Robinson Humphrey - Analyst***

Understood. The mix shift, the non-bonus products that have got the lower spread requirement, you mentioned it was 1 basis point from that mix shift. Is that kind of 1 basis point per quarter? And so, if things continue at this pace it might be a difference of 4 basis points by the time we get to next year?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

Potentially, yes. It depends on how -- if the mix of business continues to hold up, I think that's the right expectation.

Operator

John Nadel, UBS.

John Nadel ***UBS - Analyst***

Thanks for the follow-up. Ron, I think if I look historically, there's almost always a seasonal uptick in annuity sales in the fourth quarter relative to the third quarter. I guess we've seen periods where that has been interrupted by DOL or other things, but that's more typical.

So it sounds like you're seeing a pretty significant increase in applications and overall sales activity so far in the fourth quarter. I'm just curious how you would think about attributing or attribution of that uptick to what would typically be seasonal factors versus how much of that you think might actually be recovery of your market share?

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

I think that the uptick is due just to the competitiveness of our products. I don't think that there's any seasonal aspect to it. Yes, that's the answer (laughter). I think it's just competition. We are taking back some of our market share because our income is better and we've got some nice accumulation products that is capturing some attention.

Operator

(Operator Instructions). Alex Scott, Goldman Sachs.

Alex Scott ***Goldman Sachs - Analyst***

Thanks for taking one more question. I just wanted to ask if you had any thoughts on the FASB guidance, specifically for the FIA riders. I think they qualify as market risk benefits under that new approach. So, any color you can provide on the impact you'd expect from that. And if it's too early, even if you could just provide like the weighted average discount rate, that would be great.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

It is too early and I am not going to be able to provide you with the weighted average discount rate either, to answer it quickly. But certainly the changes going to be is valuing the rider, the market risk-benefit. The selection of discount rate is going to be a driver within that. And also changing the forecast for the growth in policyholder funds under management from real-life scenarios to risk neutral scenarios.

So, in general I think if we looked at that discount rate right now of how we would be looking at it compared to what our current discount rate -- you would think that the rates we are using now are maybe a little bit lower than what we would use under the rule. But we are still working through all of those pieces of it and analyzing the rule.

Alex Scott ***Goldman Sachs - Analyst***

So just a follow-up; I just want to make sure I understand it. So, the rate you're using now would potentially be lower than the rates you'd be using under the new rule? What's the dynamic that causes that?

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

That's just because of looking at currently -- we would be looking at -- I think you've got to look at some -- or under the new rule I believe it's under some fixed income medium grade type security that you're looking at for those rates.

And if you look at those rates compared to what we currently are using, it appears, at least as of right now, those rates would be higher. Now the factor that goes in is that you'd be changing that rate as you go forward under the new rule to and you would have that impact too that is different.

Alex Scott ***Goldman Sachs - Analyst***

Okay, thank you.

Ted Johnson ***American Equity Investment Life Holding Company - CFO & Treasurer***

But again, it's early and we are just in the beginning processes of looking and analyzing the rule and coming up with that. I think all the accounting firms and everybody are providing their advice and making sure that there's going to be consistency on how the rule is applied.

Alex Scott ***Goldman Sachs - Analyst***

Understood.

Operator

Pablo Singzon, JPMorgan.

Pablo Singzon ***JPMorgan - Analyst***

Thanks for my taking follow-up. So some of your competitors are selling buffer annuities or are considering entering that market. Do you believe that product is something you have to pursue especially to be a more attractive manufacturing partner in the (inaudible) and broker channel?

Ron Grensteiner ***American Equity Investment Life Insurance Company - President***

Well, those buffer annuities are securities. And so, that's a market that we don't intend on entering because we are only selling fixed products.

Operator

I show no further questions in the queue. At this time I'd like to turn the call over to Julie for final remarks.

Julie LaFollette ***American Equity Investment Life Holding Company - Investor Relations Coordinator***

Thank you for your interest in American Equity and for participating in today's call. Should you have any follow-up questions, please feel free to contact us.

Operator

Thank you, ladies and gentlemen, for attending today's conference. This concludes the program. You may all disconnect. Good day.