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BHF.OQ - Q4 2017 Brighthouse Financial Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 net income of $668m.

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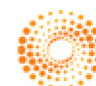

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CORPORATE PARTICIPANTS

Anant Bhalla *Brighthouse Financial, Inc. - Executive VP & CFO*

David Rosenbaum

Eric T. Steigerwalt *Brighthouse Financial, Inc. - CEO, President & Director*

Peter M. Carlson *Brighthouse Financial, Inc. - Executive VP & COO*

CONFERENCE CALL PARTICIPANTS

Erik James Bass *Autonomous Research LLP - Partner of US Life Insurance*

Humphrey Lee *Dowling & Partners Securities, LLC - Research Analyst*

Jamminder Singh Bhullar *JP Morgan Chase & Co, Research Division - Senior Analyst*

Joshua David Shanker *Deutsche Bank AG, Research Division - Research Analyst*

Ryan Joel Krueger *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Sean Robert Dargan *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Suneet Laxman L. Kamath *Citigroup Inc, Research Division - MD*

Taylor Alexander Scott *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Thomas George Gallagher *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Brighthouse Financial's Fourth Quarter 2017 Earnings Conference Call. My name is Sandra, and I will be your coordinator today. (Operator Instructions) As a reminder, the conference is being recorded for replay purposes. (Operator Instructions)

I would now like to turn the presentation over to David Rosenbaum, Head of Investor Relations. Mr. Rosenbaum, you may proceed.

David Rosenbaum

Thank you, operator. Good morning, and thank you for joining Brighthouse Financial's Fourth Quarter 2017 Earnings Call.

Our earnings release and financial supplement were released last night and can be accessed on the Investor Relations section of our website at brighthousefinancial.com. We encourage you to review all of these materials.

Today, you will hear from Eric Steigerwalt, our President and Chief Executive Officer; followed by Anant Bhalla, our Chief Financial Officer. Following our prepared comments, we will open the call up for a question-and-answer period.

Also here with us today to participate in the discussions are other members of senior management.

Our discussion during this call will include forward-looking statements within the meaning of the federal securities laws. Brighthouse Financial's actual results may differ materially from the results anticipated in the forward-looking statements as a result of risks and uncertainties including those described from time to time in Brighthouse Financial's filings with the U.S. Securities and Exchange Commission.

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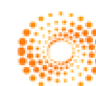

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Information discussed on today's call speaks only as of today, February 13, 2018. The company undertakes no obligation to update any information discussed on today's call.

During this call, we will be discussing certain financial measures not based on generally accepted accounting principles, also known as non-GAAP measures. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measures and related definitions may be found on the Investor Relations portion of our website, in our earnings release and in our financial supplement.

Following recent SEC guidance, we changed the nomenclature for operating earnings to adjusted earnings while retaining the definition.

And finally, references to statutory results are preliminary due to the timing of the filing of the statutory statements.

And now I'll turn the call over to our CEO, Eric Steigerwalt.

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

Thank you, David, and good morning, everyone. 2017 was a transformative year for Brighthouse Financial. In March, we began offering annuity and life insurance products under the Brighthouse Financial name. Over the course of the year, we rolled out a focused set of advertising campaigns designed to introduce our brand and showcase our flagship Shield annuities. These campaigns have helped generate brand awareness in the market and allowed us to hit the ground running as a new public company. I believe our sales results this quarter reflect that momentum.

In June, we established the long-term capital structure for the company with a very successful inaugural debt offering. Specifically, we issued $3 billion of bonds equally split between 10- and 30-year maturities at attractive coupon rates.

Of course, the highlight of 2017, a year with many important milestones, was our separation from MetLife on August 4 and our listing on the Nasdaq Stock Market on August 7. And today, we are reporting earnings for the fourth quarter of 2017, our first full quarter as a stand-alone public company.

Overall, I feel very good about our progress relative to our plans.

With that as a backdrop, I will now discuss 3 topics: first, I'll touch on progress made on the product and distribution front. Next, I will make a few comments on our fourth quarter results. And lastly, I will provide some perspectives on 2 regulatory items impacting our industry.

Let me start with product and distribution. As I stated earlier, I'm very pleased with our annuity sales results in 2017 and the sales momentum we have carried into 2018. Our distribution partners, their advisers and the clients they serve have responded positively to our strategy and positioning as a focused annuity and life insurance company in the U.S. We see continued excitement from distribution partners that have worked with us for years and inbound interest from those that may want to explore a strategic relationship going forward. As a focused manufacturer of annuity and life solutions, we highly value and benefit from our distribution partnerships. We believe our fourth quarter sales results reflect strengthening relationships and solid sales momentum.

Our annuity sales were up 25% sequentially and 26% quarter-over-quarter. Sales of our Shield annuities were $794 million in the quarter, up 22% sequentially and up 74% quarter-over-quarter.

In late July, we celebrated the launch of Index Horizons, the first product to be created as part of our 10-year distribution agreement with MassMutual. Index Horizons is a white-label, fixed-index annuity sold by MassMutual advisers. Brighthouse Financial assumes 90% of the economics through reinsurance with assumed sales of this product of approximately $203 million in the quarter, up from $69 million last quarter. We are pleased with the continued success of Index Horizons and excited to leverage our partnership with MassMutual's more than 9,000 advisers.

We plan to continue to offer new products that are simpler, more transparent and provide value to advisers, clients and our shareholders, and we will continue to listen to feedback from our partners and make product updates that respond to the evolving needs of their businesses.

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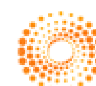

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Just yesterday, we launched a new version of FlexChoice, our guaranteed minimum withdrawal benefit rider available on our VA platform. This updated version of FlexChoice provides access to more investment options, giving advisers greater control to help build lifetime income for their clients. We believe this update strengthens our VA portfolio and serves as an excellent complement to our suite of Shield annuities.

Now I'd like to take a moment to provide a few comments on our fourth quarter results. First, I'm very pleased that the variable annuity capital strategy performed in line with our expectations, resulting in $2.6 billion of assets above CTE95 at quarter end. This gets us closer to our goal of $3 billion, which is an important milestone and the level at which we expect to begin returning capital to shareholders.

Second, our corporate expenses were $287 million in the quarter, up from the third quarter but in line with our annual run rate expectation in our first year post separation of between $1 billion and $1.1 billion. Expenses are a key metric for us. As I have said before, a part of our business strategy is to be a cost-competitive manufacturer over time. Exiting transition service agreements or TSAs with MetLife and replacing them with more cost-effective solutions is essential to executing this strategy. We have made good progress and were able to exit 72 of our TSAs in 2017. We ended the year with 147 TSAs remaining. We will continue to prioritize exiting TSAs during 2018, and we believe this will put us in a position to begin reducing our expenses in the second half of the year.

As part of our strategy, we are also making necessary investments in our technology infrastructure and in our businesses. We refer to these investments as establishment costs. In the fourth quarter, establishment costs were approximately $72 million pretax.

Third, underwriting. We experienced elevated mortality in our life insurance businesses sequentially, but within normal quarterly variation. All in, the growth in expenses and unfavorable underwriting impacted results sequentially.

Finally, I'd like to provide a few comments on group annuity reserves. In December, MetLife announced that it was undertaking a review of the practices and procedures it uses to estimate its reserves related to certain group annuitants who have been unresponsive or missing over time. And as a result of that review and based on information provided by MetLife, we have identified approximately 14,000 group annuitants across Brighthouse entities who may be owed annuity payments now or in the future. This drove a reserve increase of $38 million after tax in the quarter. This reserve increase related to legacy nonretail group annuity contracts that are all pension-risk transfer business in our Run-off segment and are administered by MetLife. We do not believe these issues impact the retail business that is also administered by MetLife as part of our TSAs.

Brighthouse Financial is committed to delivering on our promises. We are actively working with MetLife on this matter, are continuing to receive and review information and are monitoring for any other potential impacts. Anant will provide more detail on our fourth quarter results shortly.

Before I turn the call over to him, I want to spend a few minutes covering 2 regulatory items impacting our industry. Last year, I worked with a group of life insurance CEOs on Capitol Hill in an effort to achieve a balanced outcome for our industry, and I believe we achieved that outcome. Specifically, for Brighthouse, we expect to operate with a lower GAAP effective tax rate going forward and we recorded a favorable impact to book value of approximately $950 million in the quarter.

Another important regulatory item we are actively working through in 2018 is VA capital reform. As you may recall, we utilized the results of the quantitative impact study conducted for the NAIC Variable Annuity Reserve and Capital Reform initiative as an input as well as 1 additional year of our own experience in conducting our third quarter 2017 assumption review. And late last year, the current proposal and recommendations for VA capital reform were made public. We are supportive of the principles behind this initiative and believe it aligns with our view of managing to a total asset requirement. There are many details to work through with the regulators in 2018 including a 3-month public comment period, followed by a period of further regulator and industry engagement. Implementation would likely be year-end 2019 or later with a phase-in over a few years.

We have multiple levers that we can utilize to adapt to the impacts of evolving regulatory and capital requirements. For example, with our leverage ratio of approximately 22% and a target leverage ratio of 25%, we have significant financial flexibility to address any potential impacts. We remain focused on growing assets above CTE95 and managing through NAIC reform.

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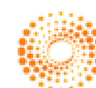

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I began my remarks by noting that 2017 was a transformative year for Brighthouse Financial, and I feel very good about our progress relative to our plans. We expect 2018 will be an equally transformative year for the company, and we believe we are well positioned to take advantage of the macro environment and proactively adjust to the evolving regulatory landscape.

With that, I'll turn the call over to Anant to discuss our fourth quarter financial results in more detail.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thank you, Eric, and good morning, everyone. Today, I will discuss our results for the fourth quarter and provide some perspective on the key underlying themes.

Net income in the quarter was $668 million compared to a net loss of approximately $1.8 billion in the fourth quarter of 2016. Adjusted earnings were $992 million in the quarter compared to an adjusted loss of $61 million in the fourth quarter of 2016. Our fourth quarter ending book value excluding accumulated other comprehensive income or AOCI was approximately $110 per share. Results in the fourth quarter included a $947 million favorable impact related to the enactment of the Tax Cuts and Jobs Act, also referred to as tax reform. Excluding the impact of tax reform, adjusted earnings would have been $45 million.

The enactment of tax reform during the quarter had a significant impact on our financial results. I'd like to spend a few minutes discussing this impact and the implications from tax reform going forward.

A key element of tax reform involved remeasuring our deferred tax assets and liabilities on both a GAAP and statutory basis. The impact of this remeasurement increased stockholders' equity excluding AOCI by $947 million. However, the FASB is currently considering an accounting rule change to address an unintended impact of tax reform within the components of stockholders' equity. As a result, once the FASB's proposed change is adopted, we expect to reclassify approximately $300 million from AOCI to retained earnings. This will reduce stockholders' equity excluding AOCI by a corresponding amount, but will not change total stockholders' equity. We expect to reflect this in our year-end financial statements to be included in our 2017 10-K filing.

Book value excluding AOCI adjusted for this reclassification is estimated to be approximately $107 per share. On a statutory basis, after factoring in tax reform, there was a minimal change in admitted deferred tax assets and therefore a minimal impact on the combined total adjusted capital of our operating companies.

Our preliminary combined risk-based capital or RBC ratio as of year-end 2017 is estimated to be well in excess of 600%.

The industry and the NAIC are starting to work through how and when the NAIC will modify the RBC methodology to reflect the new tax environment. We estimate that our preliminary combined RBC ratio as of year-end 2017 would have been well in excess of 500% if the tax rates used in this calculation were changed from 35% to 21% at the end of the year.

On a go-forward basis, as a result of tax reform, we expect our adjusted earnings tax provision rate to be in the mid- to high teens.

In terms of cash taxes that impact statutory results, we expect a negligible impact from tax reform in the next couple of years.

Finally, we expect no change to our financial targets from tax reform. We continue to anticipate in our base case scenario an adjusted ROE of approximately 8% on average and over time and adjusted EPS annual growth of mid- to high single digits starting in 2019 as we reduce expenses.

When it comes to capital distribution to shareholders, under our base case scenario, we anticipate returning in excess of $1 billion of capital to shareholders through 2021. This expected level of capital return is consistent with our previously stated target of 50% to 70% of adjusted earnings. However, going forward, we expect to refer to a cash distribution target in terms of dollars of capital only, given our focus on statutory results.

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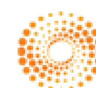

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Turning back to earnings. In addition to the favorable impact of tax reform, there were 4 unfavorable notable items in the quarter that impacted adjusted earnings. These total $152 million after tax or $1.27 per share. Specifically, $53 million of reserve adjustments in the Run-off segment due to the recapture of reinsurance on universal life with secondary guarantees or ULSG, partially offset by reserve refinements; $47 million of establishment costs related to our technology transformation and branding initiatives; a $38 million increase in reserves in the Run-off segment for legacy nonretail group annuity contracts, these contracts are all pension-risk transfer business and are administered by MetLife; and finally, a $14 million tax additional item related to separation.

Now I'd like to provide some perspectives on 3 themes that impacted our overall financial performance this quarter. The first theme for the quarter is variable annuity exposure management. As a reminder, we are managing our variable annuity business to a total asset requirement floor level known as CTE95. CTE95 is defined as the amount of assets required to satisfy contract holder obligations across future market environments in the average of the worst 5% of a thousand capital market scenarios over the life of the contract. Assets above CTE95 were $2.6 billion, up $300 million on a sequential basis. We are very pleased with this result. The hedging program performed in line with our expectations, and combined with a strong equity market in the fourth quarter, contributed approximately $500 million to the growth in assets above CTE95. This was partially offset by the normal quarterly aging of CTE95 of approximately $200 million.

The second theme for the quarter is unfavorable underwriting. This impacted results across our life insurance businesses sequentially, primarily in the Run-off segment. Specifically, we saw incremental ULSG reserve growth and elevated mortality claims mainly due to increased severity. Sequentially, underwriting results negatively impacted adjusted earnings by about $45 million. While full year direct claims in 2017 were better than the prior year, we do have higher life mortality retention as a stand-alone company. And as we've previously shared, mortality results plus ULSG reserve changes can vary from quarter-to-quarter.

The last theme for the quarter I would like to discuss is expenses. Corporate expenses were $287 million pretax in the quarter, up approximately $46 million pretax compared to the third quarter of 2017. Corporate expenses do not include the $72 million of pretax or $47 million of after-tax impact of establishment costs that I mentioned earlier. As we make investments in our infrastructure over the next few years, we anticipate establishment costs to be approximately $40 million to $50 million after-tax per quarter. It is important to note that these establishment costs are already factored into our capital plan. Eric mentioned that one of our goals is to be a cost-competitive manufacturer over time. A tangible example of executing this goal is a recent partnership that we entered into with DXC Technology to outsource in-force administration and servicing, new business processing and support operations. This partnership with an industry-leading provider is expected to enable us to migrate to a more variable cost structure, thereby lowering our operating expenses over time. I look forward to updating you on our progress in this regard on future earnings calls.

Turning to results at the segment level. Adjusted earnings in the Annuities segment were $208 million in the quarter. Strong equity markets offset continued negative net flows, resulting in a $1.7 billion sequential increase in annuity account values to $133 billion. Sequentially, results reflected higher expenses, consistent with the increase in corporate expenses. Given its relative size, we allocate a majority of the corporate expenses to the Annuities segment.

Adjusted earnings in the Life segment were $5 million in the quarter, impacted by elevated mortality sequentially.

The adjusted loss in the Run-off segment was $80 million in the quarter including unfavorable notable items of $91 million. ULSG mortality results and reserve growth were unfavorable sequentially. Expenses were also higher sequentially.

Let me close with an update on our capital position as of year-end 2017. First, preliminary combined total adjusted capital or TAC was $6.6 billion, in line with the prior quarter.

Second, as I mentioned earlier, our preliminary combined risk-based capital or RBC ratio is estimated to be well in excess of 600%.

Third, variable annuity assets above CTE95 increased to $2.6 billion. Our plan is to grow the assets above CTE95 to $3 billion under our base case scenario. This is an important milestone before we begin returning capital to shareholders. Additionally, we anticipate updating our variable annuity and ULSG sensitivities in our mid-March Form 10-K filing.

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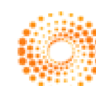

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Fourth, liquid assets at the holding companies were $655 million or about 4x our expected annual fixed charges.

And finally, our leverage ratio of approximately 22% is below our target of 25%. This provides us financial flexibility in managing our overall capital position and allows us to be opportunistic in accessing the capital markets.

With that, we'd like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Tom Gallagher with Evercore.

Thomas George Gallagher - *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

First question on the ROE guidance. Anant, the 8% that you're still guiding to, despite having a pretty big drop in the expected GAAP tax rate, are you telling us that the run rate's likely to be lower than the old 8% ROE? Or is that not the right read on that?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thanks for the question. I think what we're really saying around that is that the approximate 8% on average over time is the guidance, no change from tax reform. Tax reform will be marginally better on the numerator, but the denominator did go up as well, so it rounds around 50 bps. It still stays approximately 8% on average over time.

Thomas George Gallagher - *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

So no -- from the most recent run rate of 8%, on an apples-to-apples basis, would your view be that, that's still a good run rate despite some noise in this quarter?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, the approximate 8% is still approximate 8%.

Thomas George Gallagher - *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

Okay, I just wanted to confirm that. The -- and Eric, just a question on the regulatory changes with VA. I heard what you said about flexibility, the time frame around the implementation of the new rules and just a few questions around. Does that change your view at all in terms of the timing of potentially returning capital from 2020 given that uncertainty? Or do you feel like you have enough visibility where you actually are more confident that you're kind of on your way and you have enough flexibility to get there?

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

Okay. So I'll try to thread that needle, Tom. Look, I think every management team hopes to beat their targets, right? And we're no different. We're working hard to execute on our strategy as fast as we can. I think I would wait until we get a little bit more into the year here, hear what's happening both with all the comments coming in and then the dialogue that's going to go back and forth between the industry and regulators and then we

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can have a little bit more of a basis to comment further. But I'm certainly willing to say that we want to execute on this strategy as fast as we possibly can. And if I see a point where we can update you on that, we certainly will do it.

Thomas George Gallagher - *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

Okay. And Eric, if I could just slip one more in. Any -- in light of the Voya news about their variable annuity risk transfer deal, being mindful of the fact that you guys are in a different position because VA is such a big part of your overall business, do you think there's going to be potential opportunities for Brighthouse down the road here to utilize risk transfer to optimize capital in some way, shape or form?

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

So here's what I would say about this. Obviously, there's interest in the marketplace. Everybody has seen these transactions. I've said and I'll repeat what I said on the last call, we are focused on executing on the strategy that we laid out and we laid it out in some detail. Having said that, we're always going to be evaluating our targets and we're always going to be flexible to what's going on in the marketplace. So we're executing on the strategy, but we see everything that's going on and we're continuously evaluating what's happening in the marketplace.

Operator

And our next question comes from the line of Humphrey Lee with Dowling & Partners.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Just regarding the pension risk transfer business with Met, I was just wondering if the -- if any of the TSA agreements or any of the separation agreements would contain any potential indemnification whether it's -- to Brighthouse or to Met? Any kind of arrangement like that in the separation agreement?

Peter M. Carlson - *Brighthouse Financial, Inc. - Executive VP & COO*

Humphrey, this is Pete Carlson. Thanks for the question. As you would not be surprised, we're not in a position to say much about any specifics other than we are actively reviewing this matter with MetLife and we continue to receive information and review the information from them.

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Okay, got it. And then in terms of your CTE95 as a buffer, so it was definitely a good development in the fourth quarter, but first quarter is definitely a little bit weaker on the equity markets. The volatility did pick up. So if we were to assume the first quarter will end today based on where we are in terms of equity markets and the volatility, how should we think about the asset buffer compared to your target level?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Humphrey, it's Anant. Thanks for the question. Well, we are very pleased with the way it performed in the fourth quarter, but let me take a step back and provide some perspective here. First of all, our hedging program utilizes more long-dated options with tenures between 1 to 3 years and some out even 5 years, right? Therefore, in any given quarter, we only have a fraction of the equity hedges that need to be rolled. To be specific, in each of like the first and the second quarter of this year, we have less than 10% of our equity option book that is coming up for rolling. Secondly, our cash flow projections in the Form 10 use long-term estimates for volatility in determining hedging costs, higher than where even current implied volatility is after the moves in February. So we feel very good about what we have and you'll see our updated sensitivities in the 10-K within mid-March.

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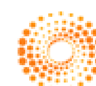

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Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Yes. But I guess, what I'm trying to get at is so obviously the decline in the equity market in the first quarter will be a headwind to the asset level above CTE95, but I would assume the high volatility would be a potential offset. So I guess, hypothetically speaking, if we end at March 31 exactly where we are right now, should we expect the asset level above CTE95 to be slightly lower than the 2.6? Or how should we think about that?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Okay. So let me break it up into the drivers and 2 drivers you can clearly see in the sensitivities that will be updated in the 10-K. One is interest rate's up. That's generally good and vice versa. Equity markets up is generally good and vice versa. So you can see the sensitivities from there that we would have. And finally, my point about volatility. Like we saw in the third quarter call, decline in implied volatility reduced the assets above CTE95. You could sort of in cue from that what vice versa would be. But I would go back to my point about the long-gated nature of our option book. Does that help?

Humphrey Lee - *Dowling & Partners Securities, LLC - Research Analyst*

Yes, okay. And then -- but should we still -- and then just for clarification of that $200 million of impact from the passage of time. Is that an annual impact? Or is that a quarterly impact?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Quarterly.

Operator

And our next question comes from the line of Alex Scott with Goldman Sachs.

Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

So the first question I had was just around the 8% ROE kind of a follow-up on Tom's question. Could you just help us think about where the run rate came in after the significant items you called out this quarter, and I know you called out the mortality as well. But like what are some of the other things you'd point to that would sort of get us back closer to 8% ROE because I sort of adjust for these things and I'm around 100 basis points lower on ROE, so I'm just trying to think about the places where maybe there is a little bit of unfavorability elsewhere.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thanks, Alex. It's Anant. And I totally understand, it's hard to pin down segment run rates 2 quarters into being a public company. So feel for you there. Let me sort of give a little bit of explanation versus last quarter and this quarter, right, ex notables in this quarter. We had $152 million of notables, so you'd get to like $197 million ex notables. We've had a swing between last quarter expenses and mortality, both having been lower to now they're higher. What I would point on mortality is while we're sequentially $45 million worse, last quarter was $20 million better. So I would look at $25 million being mortality in that and that's predominantly in ULSG. When it comes to expenses, last quarter, we had said we were $241 million, $15 million to $25 million pre-tax lower than what we would expect as a run rate. And this time, we are at $287 million. So if you sort of average those 2 quarters and look where it comes out, you would say expenses pretax at maybe around like $26 million-ish. So $15 million to $20 million post-tax. Those are what I would sort of give you as the building blocks to bridge 2 items that have been moving between the 2 quarters. Let me pause there.

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Taylor Alexander Scott - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And could you just provide some high-level commentary about the ROA in annuities of sort of the new business that you're putting on versus the old businesses running off just given the sales were good, net flows were still pretty negative based on some of the outflow, but I assume some of the outflow is probably less profitable. So just trying to think about how the mix shift of new sales versus losing some of the old will impact earnings over time.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

It's Anant again. Yes, to your point on the ROEs. Business that's running off versus business that's coming on, the one point I'd point you to as you look at the lines of the financial statement, Shield that's coming on is a lot of the new business coming on and it's not a fee-driven business. It's more an investment income-driven business, so I just point you to that.

Operator

And our next question comes from the line of Jimmy Bhullar with JPMorgan.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

I had a couple of questions. First, just if you could give us some details on the recaptured block and what drove the $58.3 million charge? And related to that, any impact of the recapture on your future earnings? I'm assuming that volatility and earnings will go up, but do you expect any impact on the base level of earnings in that business as well?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Jimmy, it's Anant again. On the second question, let me take that one first. No impact going forward. And really, it was really a GAAP-driven impact, not a statutory impact when we recaptured it and that was a big driver of our decision there. To your first question of recapturing it, we look at reinsurance rates from time-to-time and we decided that it was prudent after looking at the rates and then economically on the book of business to recapture that. We had some slight mortality given our mix of business.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

And would you -- are the policy sizes or anything else, are they similar to your in-force block? Or would you expect a little bit more volatility in earnings because the policy sizes are higher?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Nothing meaningful to comment on that. I think it's in line. It's a proportional share of our in-force block. So nothing peculiar that I would highlight for you on that. Largely in ULSG, so I would point that out. It's across both Life and ULSG. So you should see it in both going forward.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Yes. And then on the charge for the group annuity business. Did you have any control over the whole process and then -- and just trying to determine your exposure independently? Or are you just reliant on whatever information you get from MetLife on that?

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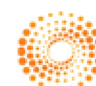

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Peter M. Carlson - *Brighthouse Financial, Inc. - Executive VP & COO*

Jimmy, It's Pete Carlson again. What I'd just remind folks on is when we did the separation, we did along legal entity lines and that's how we ended up with this product. It was, in this case, mostly came from the Travelers acquisition, issued really prior to MetLife's acquisition of Travelers. MetLife, through the TSAs is the administrator of these policies. We do receive information from them. Based on that information, we recorded our reserve, but we -- they are the administrators of the business. We actively are working with them on this and continuing to receive and review information and monitoring for any other potential impacts.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And then just lastly, clarifying on your ROE targets. I think your cash flows do include expected establishment costs, but the ROE targets do not, right?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

That is correct.

Jamminder Singh Bhullar - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And that $40 million after-tax, that's you said per quarter roughly?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

$40 million to $50 million after-tax per quarter, yes.

Operator

And our next question comes from the line of Ryan Krueger with KBW.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

I had a follow-up on volatility. I understand your longer-term comments about volatility, Anant. I was hoping you could give us some perspective on how to think about your sensitivity to increases in near-term volatility in terms of capital position. I guess, similar to the sensitivities you've given on equity markets and interest rates because, unless I'm incorrect, it seems like you would benefit from a capital standpoint from higher near-term volatility.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

You are right in that hypothesis. So I would agree with you on that because back to the point of having a long-dated option book, as volatility goes up we benefit. And what we saw in the third quarter volatility went down and we saw impact from markets and the hedging program not being as much as we had expected because of that. In the fourth quarter, while it was pretty flat, it went up just modestly. But since the end of the quarter through Friday evening, since things move around every day here, long-dated vol., 1 year vol. is up around 4 to 5 points and 2-year vol. is up around 2 to 3 points. So I'd leave it at that.

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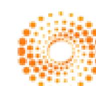

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Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

I guess, is there anything you can help us with to think about the sensitivity to you from this?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Ryan, I'd rather not give a sensitivity because these things change from time to time. Just look at what I said between 1-year and 2-year vol., right, I mean, there's such difference between the 2. But up vol. is good for us given our option book and vol. is not above where we assumed when we came up with the hedge costs. So that's where I would leave it at.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Got it. And then second question was with tax reform, you talked about the RBC impacts. Are there any -- the VA capital margin is not an RBC-based framework. Are there any impacts to how you think about and calculate the VA capital margin from tax reform on a go-forward basis?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Thanks. That's a great question. Yes, we think of VA capital reform and tax reform impacts and the whole CTE calculation in combined way, so we think of them together. And we have, as Eric mentioned and I did in our comments, we have financial flexibility with leverage only at 22% to work through that.

Ryan Joel Krueger - *Keefe, Bruyette, & Woods, Inc., Research Division - MD of Equity Research*

Okay. So there would likely be some negative impact, but you believe you can offset it with leverage?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

That's a fair point.

Operator

And our next question comes from the line of Josh Shanker with Deutsche Bank.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

Yes. I was wondering, first of all, if you can get into some detail on the $200 million of aging that occurred to the capital buffer or whatnot? How can we think about that in the future? Is this a recurring issue? Are we going to have to fight this on multiple quarters over the next few years? Sort of a framework for understanding that.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure, happy to do so. Like we shared in our third quarter call, similarly in the fourth quarter call, now the buffer is impacted by how CTE95, the liability requirement changes. And naturally, in a quarter that goes up, in a scenario like our base case scenario, you would expect CTE95 to go up over time by $200 million a quarter. As insurance liabilities age, it's almost going -- your requirements are going up till they peak and then they go down as we had highlighted in our Form 10 and will update in the 10-Q.

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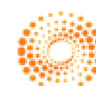

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Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

So we should expect on a normal year $800 million of aging moving against the increasing elements of the CTE buffer?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

That's right because I'd point you back to we collect almost $3 billion of fees in this business. So if you think of inflows coming in, in fees and one of the costs of that is funding your total asset requirements, reserves and capital. So around $300 million comes in each year, and to your point, around $200 million a quarter, $800 million a year would be the natural funding of the growth of the buffer.

Joshua David Shanker - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And in terms of businesses that you picked up on the statutory basis during the separation, group annuity, we didn't really have a great grasp and obviously because it's not core business do you. Are there other businesses of size that can be affected by Met's own investigation that we're not so familiar with as a noncore business that's nearly been put to you due to statutory separation?

Peter M. Carlson - *Brighthouse Financial, Inc. - Executive VP & COO*

Josh, it's Pete again. Thanks for the question. Yes, we talk about 2.7 million policyholders across all of the Brighthouse policies. For this group annuitant business, you're probably, in this pension risk transfer, you're talking 140,000 or so and less than 100,000 of those are actually in payout. When we look at it from a reserve basis, it's in the 2% to 3% of our total reserve so it's not overly significant. And what we have looked at overall, based on the information we have received from MetLife to date, we do not believe these matters impact the retail business that is also administered by MetLife as part of the TSA.

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

It's Eric. I would just add to that. If you look in the filings in the Form 10, et cetera, you can see there's a structured settlement business. That's the one I would probably point to as, I think, that was the essence of your question there, is there anything else. Obviously, we're very focused on the retail business, and now as we've said a couple of times here on this call, we don't believe that there's any issues with the retail business. But theoretically, there could be an issue in the structured settlement business. I don't know of any issue, but I think that was the essence of your call so -- of your question. So hopefully, that helps.

Operator

And our next question comes from the line of Suneet Kamath with Citi.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Anant, I want to go back to this passage of time concept. If I look at the base case from the Form 10, it looks like over a 3-year period, the passage of time would equate to something like $400 million per year, maybe $350 million per year. So I guess, I'm curious, under that, why is it closer to $200 million per quarter or $800 million per year? Am I missing a piece of it?

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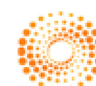

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Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

I would point you to the sensitivities when we update them in the 10-K. But as I spoke last time in the third quarter call, it is around $200 million a year. So we can take that off-line and walk you through it, so it's helpful. $200 million a quarter, sorry.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Okay. But it seems like there was change here relative to what's in the Form-10?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

No. We can sort of point to it on that like I did on the last call, I'd just point you back to my comments there. If you triangulate between 256, 257, I have to be careful because the Form 10 is a bit old now so I would really want you to look at the 10-K. But even if you look at that, page 256, 257 versus the instantaneous sensitivities, you can sort of see how passage of time gives us around $200 million a quarter in the base case.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Yes. I'm on 256 and I see that $1.1 billion in the base case.

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes -- so when we look at that, it should translate to $200 million. I don't have my Form 10 in front of me, but we can walk you through that off-line.

Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

Okay, that'd be helpful. And then, I guess, on the Oliver Wyman study, can you maybe highlight just some other variables that you're seeing in the most recent update and how they could compare to what you're currently assuming? The premise is kind of back to this idea that you have the flexibility to reflect any of these changes and I just want to get a sense of which variables we should be focusing on?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sure, thanks for that question. The -- as Eric mentioned, the dialogue and comment period will take a little bit of time to work its way through 2018 over here. However, to your specific point on the variable, there are 28 specific recommendations, if memory serves me right, which I would group into, one, 3 to 4 structural categories and the last category being how people are calibrating or parameterizing the methodology. So on the structural categories, first, it's about managing to a total asset requirement or TAR based on a high CTE requirement, just like our CTE95. So we're aligned with that. Second, it's the use of the standard scenario not as a binding requirement over the high CTE standard, but more as a validation on the impact of different companies' actuarial assumptions and models. So it's almost a validation point and where it's going towards where it's prescribed assumptions anchored in industry data like what we did in our assumption update last quarter, but at a lower CTE like I think we're talking about CTE65, so it's a validation point. And third, incentivizing long-term hedging, not just short term, and increasing disclosure, all which is congruent with the way we've designed our strategy, the way we are executing our strategy and now growing the buffer. So I rarely then go structurally. Those are my comments on the 28 proposals. Finally, it boils down to the last category of calibration of a model or parameterization of a model and that will be the focus of dialogue over the coming year, how do you calibrate scenario definitions, whether it's equity returns or interest rates? Do you look from 1955 to now? Do you go back to the '20s? Do you go back to the 1800s? And then this is a long-term business and you have to look at the long-term nature of the business and what that means for these definitions and then what CTE you pick, 93, 95, 98. That was a mouthful so I'm going to pause, but hopefully you got what you're looking for.

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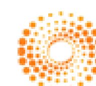

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Suneet Laxman L. Kamath - *Citigroup Inc, Research Division - MD*

No, that's helpful. Just the last one on this. So between Oliver Wyman and tax reform, it seems like there could be some negative impacts on capital, but you think that you have the financial flexibility in terms of leverage, but also holding company cash to deal with both of them?

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

Suneet, it's Eric. Here's what I would say. I think as we look at it from today's point of view, I would agree with what you just said. I mean, this -- we mentioned specifically the dialogue continues. You get more information, et cetera, et cetera. But I would agree with what you just laid out.

Operator

And our next question comes from the line of Sean Dargan with Wells Fargo.

Sean Robert Dargan - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

I have a question about the relationship between total adjusted capital and the CTE95 buffer. So tax was essentially flat quarter-over-quarter, but you did have a nice bump up in the buffer. Is that just because the CTE95 calculation is more sensitive to market movements? Or how should we think about that?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Sean, you're spot on right. The blue books are not on a CTE95 basis. Standard scenario, which really drives the blue books, is less sensitive to markets than CTE95. So you got it.

Sean Robert Dargan - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Okay. And then you may hit that targeted buffer maybe sooner than people were thinking, maybe not. But will you put out -- will you ask the board for a share repurchase authorization as soon as you hit that buffer? Or are you going to want to stay at that level for a couple of quarters to make sure that you're -- you have better insight into staying at that level?

Eric T. Steigerwalt - *Brighthouse Financial, Inc. - CEO, President & Director*

Sorry, Sean, I had my mic off. It's Eric. So we're in our second quarter here as a public company and I would say we're having discussions just like that with the board. We're watching the buffer build and stay tuned. Obviously, even what I just said is consistent with we love to be able to go faster than our targets. But we're in our second quarter as a public company, so stay tuned. But these conversations are certainly being had with the board.

Operator

And our last question comes from the line of Eric Bass with Autonomous Research.

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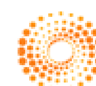

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Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

You've mentioned the significant liquidity at the holding company and -- well above your targets and it increased quarter-over-quarter. I guess, as you think about that going forward, would you expect the liquidity level to start to decline since you're not taking or not planning to take dividends from BLIC?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes, it's Anant. We are holding on 4x our fixed charge coverage. We're not planning to take dividends from BLIC till we build up to $3 billion of assets above CTE95, so yes. And our long-term targets are to be like 2x, not 4x.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. But so over the course of 2018, you would expect that directionally to move lower?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

Yes.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Okay. And then can you walk through how higher interest rates would affect your capital and balance sheet, and you mentioned the positive impacts certainly for the VA book. But are there any negative short-term implications for capital given the swaps used to hedge the ULSG well block?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

On a stat. basis, high interest rates, generally speaking, for the life insurance business is good. On a GAAP basis, I think you've hit the nail on the head there, the ULSG block in the Run-off segment is fairly insensitive on GAAP, you see that in our sensitivity filings. But we do hedge the true economic risk of that and stat. risk on that using swaps. We did dial up using options and not just swaps, so we've got a balanced mix there. But that's correct, we would see impact on GAAP equity because that's not in operating earnings. It's below the line from those swaps from mark-to-market movements. And I would just point you to sensitivities that we update in the 10-K because we'll also reflect the change in tax rates at 21% versus 35% when you do that.

Erik James Bass - *Autonomous Research LLP - Partner of US Life Insurance*

Got it. But there are no RBC impact?

Anant Bhalla - *Brighthouse Financial, Inc. - Executive VP & CFO*

No, we've done our cash flow testing analysis as well on a preliminary basis and we feel pretty good about that even though it's preliminary.

Operator

And this does conclude today's Q&A session. So I'd like to return the call to Mr. David Rosenbaum for any closing remarks.

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David Rosenbaum

Thank you for joining us today for our fourth quarter earnings call and for your interest in Brighthouse Financial. We look forward to talking again next quarter. Thank you very much.

Operator

Ladies and gentlemen, thank you for participating today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.

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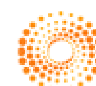

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