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Penn Mutual Life Insurance Co.

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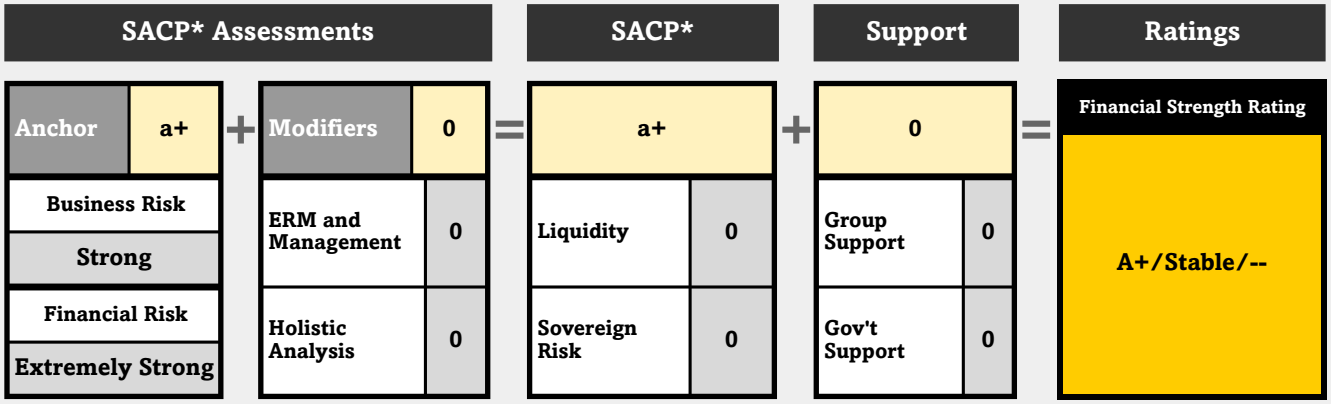
Penn Mutual Life Insurance Co.



*Stand-alone credit profile.
See Ratings Detail for a complete list of rated entities and ratings covered by this report.

Rationale

Business Risk Profile: Strong

- Strong competitive position with a solid market presence in the affluent individual life insurance and annuity markets in the U.S.
- Permanent life insurance sales above industry growth levels
- Diversified distribution channels
- Operating performance reflects strong generally accepted accounting principles (GAAP) return on assets and higher general expense ratio compared to peers'
- Exposure to prolonged low interest rates and volatile equity markets consistent with industry-wide challenges

Financial Risk Profile: Extremely Strong

- Extremely strong capital adequacy, which redundant AXXX statutory reserves in its operating companies support
- Conservative investment approach that includes high quality bonds, diversification, and no commercial mortgages
- Favorable leverage and coverage metrics, but more limited access to capital markets due to its mutual ownership structure

Other Factors

- Exceptional liquidity with good asset-liability management practices
- Neutral assessments of management, governance, and enterprise risk management practices

Outlook: Stable

The stable outlook on Penn Mutual Life Insurance Co. and its wholly owned subsidiary Penn Insurance & Annuity Co. (collectively, Penn Mutual) reflects Standard & Poor's Ratings Services' expectation that the company will maintain its strong competitive position and extremely strong capital and earnings. The increased redundancy of capital according to our models gives more stability to the current rating.

Downside scenario

We may lower our rating if the company's capitalization declines below our 'AA' confidence level, or if there is an increase in the allocation to higher risk assets, signaling an increased risk tolerance. We may also lower the company's rating if its competitive position weakens or if GAAP before-tax operating return on equity (ROE) falls below 4%.

Upside scenario

It is unlikely that we will upgrade Penn Mutual in the next two years. An upgrade would be based on extremely strong capital, coupled with an improved competitive position (greater brand differentiation, greater market share, and/or stronger operating performance).

Base-Case Scenario

Macroeconomic Assumptions

- The U.S. economy continues to improve slowly with real GDP growth of about 2.5% in 2015 and 2.7% in 2016
- Average 10-year U.S. Treasury yield of 2.2% in 2015 and 2.7% in 2016
- U.S. 'AAA' corporate bond yields of about 3% in 2015 and 3.8% in 2016
- S&P 500 Index level of 2,059 in 2015 and 2,105 in 2016
- Average payroll employment of 142 million in 2015 and 144 million in 2016

Company-Specific Assumptions

- Capital adequacy remains extremely strong and continues to exceed the prospective risk-based capital (RBC) requirement at the 'AAA' confidence level
- GAAP pretax operating income of more than $250 million in 2015 and after-tax operating return on equity (ROE) of 6%-7% for the next two years
- Statutory net income will remain positive in 2015 and beyond because of higher contributions from retained life insurance and less new business strain overall
- Leverage (debt plus hybrids to total capital on a GAAP basis) remains at roughly 19%; liquidity remains exceptional

Key Metrics

	--Year ended Dec. 31--				
(Mil. $)	**2016***	**2015***	**2014**	**2013**	**2012**
S&P capital adequacy/redundancy	AAA	AAA	AAA	AA	AA
Return on equity (%)	>5	>5	6.1	5.8	4.6
Financial leverage (%)	<20	<20	18.6	24.8	25.7
Fixed-charge coverage (x)	>6	>6	6.6	4.5	3.7
EBIT	>250	>250	240.0	229.0	182.0

*Forecast data reflect Standard & Poor's base-case assumptions.

Company Description: An Established Position In Individual Life, With Complementary Distribution Channels

Penn Mutual has established a strong position in the affluent individual life and annuity market. Penn Mutual has achieved this through its focus on relationship-oriented producers and a well-balanced emphasis on two complementary distribution channels: career agents and independent agents. Penn Mutual has consistently ranked in the top-25 companies based on total life insurance sales, and it ranked at No. 20 in 2014, according to the Life Insurance and Market Research Association (LIMRA) U.S. Individual Life Insurance Sales Survey. Revenues totaled $2.8 billion in 2014 on a statutory basis.

In addition, its retail broker-dealer subsidiary, Janney Montgomery Scott LLC (Janney), provides a diversified (noninsurance/fee-based) revenue stream, with revenue sources about 80% retail and 20% institutional.

Business Risk Profile: Strong

Insurance industry and country risk: Low

Our assessment of Penn Mutual's industry and country risk as low stems from our view of the very low country risk and intermediate industry risks in its U.S.-only life insurance operations. Stable economic growth prospects, relatively effective and stable political institutions, sophisticated financial systems, and strong payment culture in the U.S strengthen our view of low country risk for the company. In our view, Penn Mutual's life insurance operations are exposed to low industry risks because of moderate product risk, which its strong track record of maintaining asset-liability management mismatch within one year demonstrates. The availability of fixed-income instruments of sufficient duration to match insurance liabilities in the capital markets greatly supports this capability. But we believe sensitivity to interest rates and equity-market volatility offsets this strength somewhat and burdens long-term operating returns. We believe persistent low interest rates and intense competition will limit the sector's growth prospects and potential for higher operating margins.

Table 1

Industry And Country Risk		
Insurance sector	**IICRA**	**Business mix (%)**
U.S. life	Low risk	100

Competitive position: Strong

Penn Mutual has a strong competitive position, in our view, as a result of its solid market presence in the affluent individual life and annuity markets in the U.S., which its diversified and complementary national distribution channels support. Of these channels, approximately 40% are career distributors and 60% are independent, which has remained fairly consistent year-over-year. Penn Mutual does not benefit from a highly controlled distribution, which we define as originating over half of its premiums through the company's own distributors. However, we view Penn Mutual's independent channels somewhat favorably because both channels have strong productivity and performance. In addition, Penn Mutual does not differentiate between the channels, and it allows producers to change channels relatively easily.

Penn Mutual's strong sales growth of about 6% per year for the past five years, particularly from permanent life insurance sales, underscores its competitive strength. The company recorded new life insurance sales of $130 million in 2014, but this was down 6% from the previous year. Life sales for first-half 2015 totaled $69 million compared to $51.4 million for the same period the year before; 39% of 2015 sales are from whole life. Annuity sales were strategically limited in 2014 to $617 million, down 10% from the previous year. The company had $271 million in new annuity sales during first-half 2015, a decline from $297.1 million in first-half 2014.

Penn Mutual has opportunistically offered variable annuity products in an effort to penetrate both customers and distribution while building brand loyalty. However, Penn Mutual maintains annuity products in line with its risk tolerances. It has altered its annuity offerings over time to limit its exposure to guaranteed death and income benefits. However, Penn Mutual employs a comprehensive hedging strategy in order to mitigate the risks associated with specific product features. The company's efforts to de-risk its products and better align field compensation with product profitability support our expectation for longer-term improvement in its earnings profile.

Table 2

Competitive Position					
	--Year ended Dec. 31--				
(Mil. $)	**2014**	**2013**	**2012**	**2011**	**2010**
Gross premiums written	464.6	321.6	374.6	329.0	283.4
Change in gross premiums written (%)	44.5	(14.1)	13.8	16.1	N.M.
Net premiums earned	417.4	205.7	347.2	301.4	253.3
Total assets under management	19,580.1	17,615.7	16,765.2	14,770.1	13,198.7

N.M.--Not meaningful.

Financial Risk Profile: Extremely Strong

Capital and earnings: Extremely strong

In our opinion, Penn Mutual will maintain extremely strong capital and earnings under our base-case assumptions for the next two years. Our assessment of group capital improved year-over-year with the release of our new criteria that relates to the treatment of statutory life insurance reserves and reserve financing solutions.

Penn Mutual's GAAP net income grew to $110 million through first-half 2015, which was a 12% rise from the year before due to higher income from growth in Penn Mutual's in-force business. We expect the company to witness stable or improved profitability, earnings, and capital adequacy in the longer term as a result of a strategic shift in its new business mix and expense management.

Table 3

Capitalization Statistics

	--Year ended Dec. 31--				
(Mil. $)	**2014**	**2013**	**2012**	**2011**	**2010**
Common shareholders' equity	3,152.3	2,694.2	2,905.9	2,721.6	2,321.9
Change in common shareholders' equity (%)	17.0	(7.3)	6.8	17.2	N.M.
Total reported capital	3,719.6	3,204.1	3,500.9	3,160.6	2,842.4
Change in total capital (reported) (%)	16.1	(8.5)	10.8	11.2	N.M.

N.M.--Not meaningful.

Table 4

Earnings Statistics

	--Year ended Dec. 31--				
(Mil. $)	**2014**	**2013**	**2012**	**2011**	**2010**
Total revenue	2,145.5	1,845.4	1,827.5	1,651.1	1,527.8
EBIT adjusted	335.0	280.8	223.3	150.4	129.0
EBITDA adjusted	349.1	293.3	232.8	158.7	139.0
Net income (attributable to all shareholders)	177.7	162.9	129.7	90.7	85.3
Return on revenue (%)	15.6	15.2	12.2	9.1	8.9
Return on assets	1.5	1.3	1.2	0.9	0.8
Return on shareholders' equity (reported) (%)	6.1	5.8	4.6	3.6	3.4

Risk position: Intermediate

Penn Mutual's diverse and high-quality investment portfolio shapes our view of its intermediate risk position. Based on National Association of Insurance Commissioners (NAIC) ratings, approximately 97% of Penn Mutual's fixed-income investments are considered investment grade, and the portfolio has a weighted-average rating of 'A'. As of year-end 2014, the company's exposure to high-risk assets has decreased to 63% of total adjusted capital compared to 88% the prior year. In addition to prudently managing its assets and liabilities, the company is successfully hedging its product risk.

Penn Mutual invests in structured securities such as commercial mortgage-backed securities (CMBS), which make up 19% of fixed-income assets; residential mortgage-backed securities, which make up 4%; and other loan-backed structured securities, which make up 8%, as of June 30, 2015. Typically, the company invests primarily in the relatively

stable tranches of securities that have more predictable cash-flow characteristics in order to limit risks. Penn Mutual's CMBS portfolio could potentially be problematic if the macroeconomic environment deteriorates, in our view. However, we do not consider this in our base-case assumptions because of the moderate economic recovery. In addition, we recognize that Penn Mutual's CMBS portfolio has not experienced credit impairments since 1996, and its overall exposure declined in 2014.

Table 5

Risk Position

	--Year ended Dec. 31--				
(Mil. $)	**2014**	**2013**	**2012**	**2011**	**2010**
Total invested assets	19,580.1	17,615.7	16,765.2	14,770.1	13,198.7
Net investment income	614.7	552.8	510.7	450.8	419.8
Net investment yield (%)	5.3	5.0	4.8	4.8	4.8
Net investment yield including realized capital gains/(losses) (%)	4.9	5.1	5.0	4.9	4.8
Portfolio composition (% of general account invested assets)					
Cash and short-term investments (%)	2.4	1.5	1.7	1.6	1.2
Bonds (%)	85.6	87.3	87.7	86.4	85.5
Equity investments (%)	1.3	0.4	0.4	0.7	0.5
Real estate (%)	0.2	0.2	0.1	0.1	0.2
Loans (%)	5.9	6.6	6.3	7.0	8.1
Other investments (%)	4.5	4.0	3.8	4.1	4.5

Financial flexibility: Adequate

Penn Mutual has adequate financial flexibility with favorable leverage and coverage metrics. Because Penn Mutual is a mutual insurance company, issuance of surplus notes is its only direct means of access to external capital. The company also has facilities with federal home loan banks.

The company has demonstrated its ability to access the capital markets with its first surplus note issuance of $200 million in 2004, which it repeated with another note issuance of $200 million in 2010. Moreover, we view the company's capitalization adequate to support its plan for modest growth in upcoming years.

Table 6

Financial Flexibility

	--Year ended Dec. 31--				
(Mil. $)	**2014**	**2013**	**2012**	**2011**	**2010**
EBITDA fixed-charge coverage including realized and unrealized gains/(losses) (x)	4.8	3.7	3.1	2.3	2.3
EBITDA fixed-charge coverage (x)	6.6	4.5	3.7	3.2	3.2
Financial leverage including pension deficit as debt (%)	18.6	24.8	25.7	22.2	23.5

Other Assessments

We consider Penn Mutual's adequate enterprise risk management (ERM) program and its satisfactory management and governance practices consistent with our ratings. Its liquidity is exceptional, in our view.

Enterprise risk management: Adequate

Penn Mutual's ERM is built on a long-standing risk management culture and is embedded in key business functions. The company has adequate controls in place for asset-liability management (ALM), credit exposure, and investment limits. ALM and capital management committees provide structure and oversight of risk management. The company's chief risk officer also serves as chief ethics officer. The company measures its key risks against its risk appetite statement, and stress tests inform strategic decisions. In addition, the company uses programs from outside consultants to hedge its more complicated risks. However, a third party has not performed an independent risk assessment of the company.

Our ERM assessment does not carry much weight in the overall rating because we consider Penn Mutual's risks less complex than other insurance companies' due to its large block of stable whole-life products and level of excess capital. However, we believe the importance of ERM to the rating is growing as Penn Mutual expands and increases its products with higher risk, such as variable and universal life, which creates greater equity risk and need for hedging.

Management and governance: Satisfactory

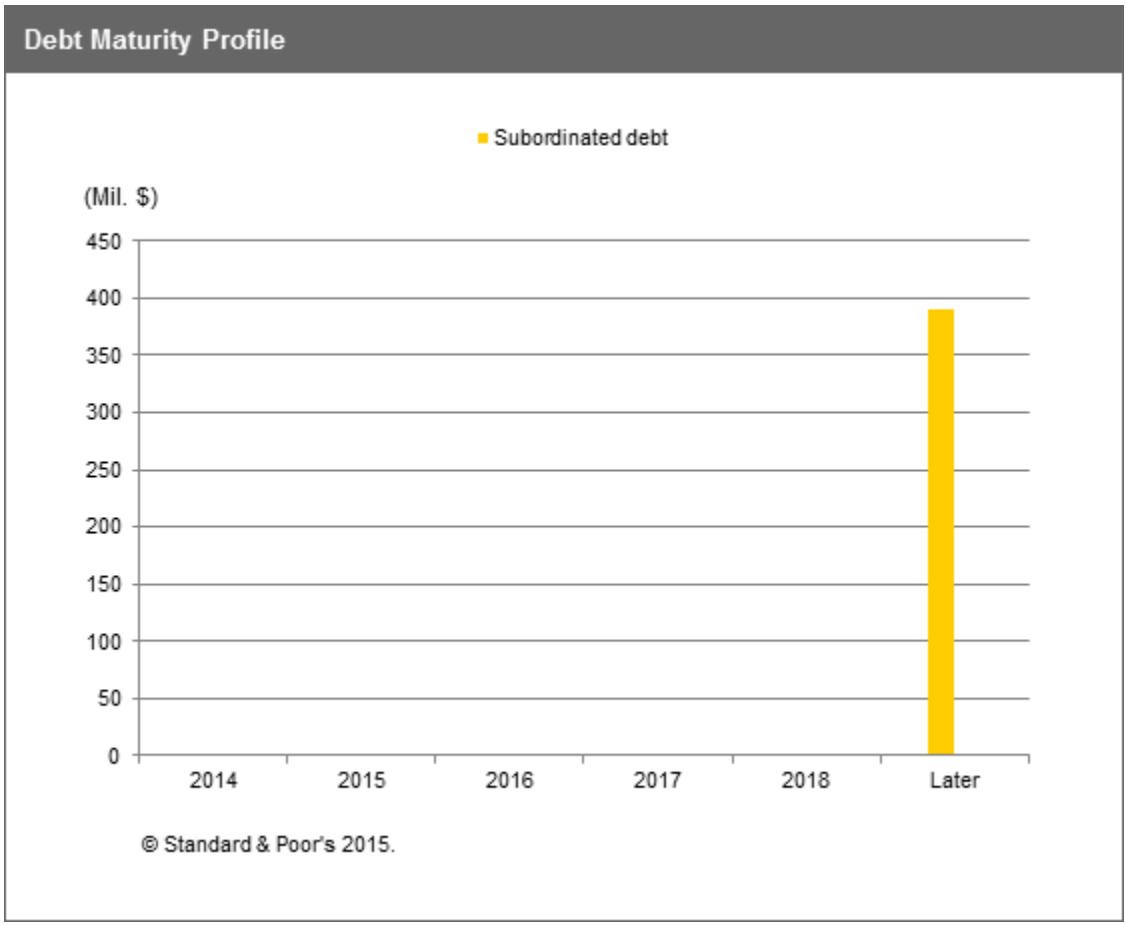
Our view of Penn Mutual's management and governance is satisfactory, based on the company's effective strategic planning process, operational performance and effectiveness, financial management, and governance. We believe management is of sufficient depth and has expertise in operating its major business lines. The company effectively adapts to changes in market conditions and observes the market's response to innovations before launching competing products. In addition, management generally designs its products with fewer features, but it prices them slightly lower than market leaders, which has resulted in robust sales of simple products.

The company's mutual ownership structure (versus a stock ownership structure) facilitates the execution of management's long-term strategy, which is to provide face-to-face value-added distribution to affluent markets. Furthermore, the mutual ownership structure gives management enough flexibility to undertake other long-term initiatives such as making significant investments in information technology and strengthening and expanding its well-diversified distribution network.

Liquidity: Exceptional

We consider Penn Mutual's liquidity exceptional. At year-end 2014, the company had a liquidity ratio of 300%, and it has a high credit-quality investment portfolio, 97% of which consists of investment-grade investments and liquid investments. These resources are ample to meet any immediate liquidity needs, in our view. Penn Mutual also faces limited exposure to confidence-sensitive liabilities.

Chart 1



Accounting Considerations

We note that Penn Mutual, as a mutual company, is not required to produce audited GAAP financial statements. However, management provides summary GAAP statements, which PricewaterhouseCoopers audits. The auditor provided an unqualified opinion for the 2014 financial statements. We primarily analyze Penn Mutual's operating performance based on GAAP after-tax operating income (excluding the corporate segment and realized gains).

Penn Mutual's statutory capital base includes $400 million of surplus notes (one $200 million 30-year note issued in 2004, and a second $200 million 30-year note issued in 2010), both of which contribute to long-term capital. However, we do not give full equity credit to the 2010 issuance because combined proceeds for the two surplus notes exceed the 15% maximum for capital credit under our criteria.

Related Criteria And Research

- Methodology: Treatment Of U.S. Life Insurance Reserves And Reserve Financing Transactions, March 12, 2015
- Methodology For Assessing Capital Charges For U.S. RMBS And CMBS Securities Held By Insurance Companies,

Aug. 29, 2014
- Group Rating Methodology, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Calculating The Convexity Risk In U.S. Insurance Risk-Based Capital Model, April 27, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- Life: Liquidity, April 22, 2004

Ratings Detail (As Of December 15, 2015)	
Operating Companies Covered By This Report	
Penn Mutual Life Insurance Co.	
Financial Strength Rating	
Local Currency	A+/Stable/--
Counterparty Credit Rating	
Local Currency	A+/Stable/NR
Subordinated	A-
Penn Insurance & Annuity Co.	
Financial Strength Rating	
Local Currency	A+/Stable/--
Issuer Credit Rating	
Local Currency	A+/Stable/--
Domicile	Pennsylvania

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.