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Ohio National Financial Services Inc. And Its Operating Subsidiaries

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Ohio National Financial Services Inc. And Its Operating Subsidiaries

SACP* Assessments				SACP*		Support		Ratings			
Anchor	aa-	+	Modifiers	-1	=	a+		+	0	=	Financial Strength Rating
Business Risk			ERM and Management	-1		Liquidity	0		Group Support	0	A+ / Stable / --
Very Strong			Holistic Analysis	0		Sovereign Risk	0		Gov't Support	0	Holding Company Rating
Financial Risk											BBB+ / Stable / --
Very Strong											

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

Rationale

Business Risk Profile: Very Strong

- Very strong competitive position supported by a long track record of year-over-year (y/y) consecutive sales growth
- Reliance on riskier annuity products to boost earnings

Financial Risk Profile: Very Strong

- Very strong capital and earnings anchored by our expectation that capital will remain significantly redundant at 'AA'
- Intermediate risk position reflecting relatively well-diversified investment portfolio with limited exposure to defined-benefit pension liabilities
- More constrained financial flexibility than other mutuals, but still adequate for the rating

Other Factors

- Adequate enterprise risk management (ERM) of high importance to the rating given exposure to variable annuities (VAs) with living benefits

Outlook: Stable

The stable outlook on Ohio National Financial Services Inc. (ONFS) reflects S&P Global Ratings' expectation that ONFS will maintain 'AA' capital adequacy and continue its consistent track record of life insurance sales growth while maintaining historically favorable lapse and mortality metrics.

Downside scenario

We could lower the ratings if the group's competitive position weakens as shown by a decline in life sales or heightened lapse or mortality experience, or if capital weakened significantly below the 'AA' level.

Upside scenario

We could raise the rating if ONFS' ERM program maintains its strong risk controls, or if we believe capital adequacy will sustainably improve to be redundant at 'AAA' per our model.

Base-Case Scenario**Macroeconomic Assumptions**

- U.S. real GDP growth of about 1.6% in 2016 and 2.4% in 2017
- Average 10-year U.S. Treasury yield of about 1.8% in 2016 and 2.4% in 2017
- U.S. 'AAA' corporate bond yields of about 2.7% in 2016 and 3.3% in 2017
- Average S&P 500 Index level of 2,089 in 2016 and 2,226 in 2017
- Average U.S. payroll employment of 144 million in 2016 and 146 million in 2017

Key Metrics

	--Year ended Dec. 31--				
	2017*	2016*	2015	2014	2013
Financial leverage (%)	29	30	31	31	29
S&P Global Ratings capital adequacy/redundancy	AA	AA	AA	AAA	AA

*Forecast data reflect Standard & Poor's base-case assumptions. Financial leverage is based on GAAP.

Company Description

ONFS, along with its operating companies, Ohio National Life Insurance Co. and Ohio National Life Assurance Corp., is a mutual company based in Cincinnati, Ohio. ONFS focuses mainly on individual life products, like whole, term, and universal life, as well as individual annuities (both VA with living benefit guarantees and fixed). The group sells its life products through its general and career agency distribution network, and sells its annuities through securities brokerages, independent broker-dealers, and financial institutions. ONFS also offers disability income products.

Business Risk Profile: Very Strong

Insurance industry and country risk

ONFS operates in the highly developed U.S. life insurance market and faces low industry and country risk. Our view of very low country risk reflects the stable economic growth prospects, sophisticated financial systems, and strong payment culture in the U.S. We believe industry risk for U.S. life insurance is intermediate based on profitability (as measured by return on equity), product risk, barriers to entry, market growth prospects, and institutional framework. We view these factors as neutral for the life insurance sector, but sustained low-interest rates somewhat dampen long-term operating return prospects because yields may be depressed.

Table 1

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

Competitive position

We consider ONFS' competitive position very strong and supportive of the rating. The company's well-established profit-sharing plan with its life distribution has produced favorable mortality results and consistent y/y sales growth for many years. This plan is a clear strength to ONFS' competitive position. Its variable cost structure has allowed ONFS to consistently maintain expense ratios well below those of its peers and fostered growth. Low expense ratios and favorable mortality have allowed ONFS to offer competitively priced whole life products. In 2015, whole life was the primary driver of individual life sales growth (20% versus the industry average of about 3%). ONFS is well-diversified geographically, with a large footprint across the U.S. We believe ONFS has a sustainable competitive advantage in the individual life insurance sector.

Table 2

Ohio National Combined Competitive Position					
	--Year ended Dec. 31--				
(Mil. \$)	2015	2014	2013	2012	2011
Gross premiums and annuity considerations	3,463.4	3,637.3	3,624.8	3,974.3	2,611.0
Change in gross premiums and annuity considerations (%)	(4.8)	0.3	(8.8)	52.2	7.6
Net premiums and annuity considerations	2,821.2	3,040.1	3,109.2	3,487.1	2,154.3
Change in net premiums and annuity considerations (%)	(7.2)	(2.2)	(10.8)	61.9	3.4
Total assets under management	31,400.2	30,759.1	28,476.2	24,943.6	20,969.1
Growth in total assets under management (%)	2.1	8.0	14.2	19.0	0.4

2015 includes National Security Life and Annuity Co., whereas prior years do not.

ONFS has seen solid growth in its annuity business recently, particularly in its VA with living benefit guarantees segment. Its competitive position has been buoyed by a reduced market appetite from many major players, which has lowered supply, while earnings have been boosted by strong equity markets. Few mutual peers offer VA with living benefit guarantees because the product is associated with significant reserve volatility in certain markets. We believe ONFS' product offerings are more conservative than similar products offered by public companies. ONFS has adopted

managed volatility portfolios (MVP) and all its VA products have required the use of MVP funds since 2012. It's also mitigated much of its risk via reinsurance and coinsurance.

Overall, however, a key risk to ONFS' business risk profile is its reliance on annuity products as a percentage of earnings--up to 53% in 2015 from 45% in 2012, but lower than 55% in 2014. Annuities are a higher-risk, lower-margin product than ONFS' traditional life products. We expect ONFS to continue on this course and for life insurance products to make up a growing proportion of earnings in the next three years. Although a balance of life and annuities earnings makes for good diversification, if the mix were to shift materially and consistently toward annuities as the primary driver of earnings, it would be a negative credit factor, in our view.

Financial Risk Profile: Very Strong

Capital and earnings

We consider ONFS' capital and earnings as very strong. Capital has been relatively stable over the past few years; as of year-end 2015, it was redundant at the 'AA' level per our risk-based capital model, and we expect it to remain at least so. We believe statutory net income may become more volatile as ONFS continues to hedge the equity risk exposures in its VA business.

Table 3

Ohio National Combined Capitalization Statistics					
--Year ended Dec. 31--					
(Mil. \$)	2015	2014	2013	2012	2011
Total assets	31,400.2	30,759.1	28,476.2	24,943.6	20,969.1
Adjusted total assets	31,377.0	30,736.1	28,462.5	24,922.6	20,947.7
Capital and surplus	1,087.2	1,097.1	1,002.7	1,048.3	902.5
Change in capital and surplus (%)	(0.9)	9.4	(4.3)	16.2	4.9
Total adjusted capital (TAC)	1,191.6	1,185.7	1,079.6	1,465.8	961.8
Change in TAC (%)	0.5	9.8	(26.3)	52.4	5.7

2015 includes National Security Life and Annuity Co., whereas prior years do not.

Table 4

Ohio National Combined Earnings Statistics					
--Year ended Dec. 31--					
(Mil. \$)	2015	2014	2013	2012	2011
Total revenue	3,987.5	4,147.8	4,132.1	4,429.1	3,109.0
EBIT adjusted	109.7	163.8	132.5	213.4	170.2
Net income	84.9	108.5	75.2	146.6	108.0
Return on revenue (%)	2.7	3.9	3.2	4.8	5.5
Return on revenue (including realized gains/losses) (%)	2.3	3.5	2.4	4.0	5.3
Return on assets (excluding realized gains/losses) (%)	0.4	0.6	0.5	0.9	0.8
Return on capital and surplus (%)	7.8	10.3	7.3	15.0	12.2
Expense ratio (%)	16.4	13.7	12.6	10.6	10.9
General expense ratio (%)	6.2	5.1	4.5	3.4	5.5

Table 4

Ohio National Combined Earnings Statistics (cont.)					
(Mil. \$)	--Year ended Dec. 31--				
	2015	2014	2013	2012	2011
Prebonus pretax earnings / total assets (%)	0.6	0.8	0.7	1.1	1.0

2015 includes National Security Life and Annuity Co., whereas prior years do not.

Risk position

We view ONFS' risk position as intermediate. It has limited exposure to pension obligations--it discontinued the defined benefit plan in 1997 and its investment portfolio is well-diversified with limited high-risk assets. The company has relatively high exposure to 'BBB' rated bonds and its commercial mortgage loan portfolio, but we consider these risks well managed and neutral to the rating.

Table 5

Ohio National Combined Risk Position					
(Mil. \$)	--Year ended Dec. 31--				
	2015	2014	2013	2012	2011
Total invested assets (incl. affiliated investments)	10,214.0	9,701.3	9,136.5	9,237.7	8,536.1
Change in total invested assets (%)	5.3	6.2	(1.1)	8.2	(1.9)
Separate account assets	20,494.7	20,343.0	18,668.5	15,052.2	11,743.3
Net investment income	498.4	484.1	475.8	483.8	493.4
Realized capital gains/(losses)	(16.5)	(20.5)	(34.8)	(38.8)	(5.2)
Unrealized gains/(losses)	286.1	550.9	311.0	672.4	437.8
Net investment yield (%)	5.0	5.1	5.2	5.4	5.7
Net investment yield including realized capital gains/(losses) (%)	4.8	4.9	4.8	5.0	5.7
Net investment yield including all gains/(losses) (%)	7.7	10.8	8.2	12.6	10.7
Portfolio composition (% of general account invested assets)					
Cash and short-term investments	4.1	3.4	3.3	3.8	3.8
Bonds	72.8	72.0	71.8	66.7	68.4
Real estate	0.3	0.2	0.3	0.0	0.0
Mortgages	11.1	11.7	13.0	13.6	14.5
Investments in affiliates	4.0	4.4	4.8	4.8	5.6
Investments in partnerships, joint ventures, and other alternative investments	0.1	0.1	0.1	0.1	0.0
Other investments	7.6	8.2	6.6	10.9	7.6

2015 includes National Security Life and Annuity Co., whereas prior years do not.

Financial flexibility

We consider ONFS' financial flexibility as adequate but constrained. It had higher financial leverage, about 31% as of year-end 2015, than most of its mutual peers. The company's debt-funded double leverage (including surplus notes that mature within the next 20 years) already slightly exceeds our tolerance of 20%, so any additional debt issuance would not be fully accretive to capital. For 2015, adjusted generally accepted accounting principles (GAAP) EBITDA fixed-charge coverage was about 3.31x. We expect run-rate adjusted GAAP EBITDA fixed-charge coverage of about 4x, at the low end of what we consider neutral for the metric.

Table 6

Ohio National Combined Financial Flexibility					
--Year ended Dec. 31--					
(Mil. \$)	2015	2014	2013	2012	2011
Cash Flows (Statutory)					
Net cash flow from operating activities	583.6	451.5	381.6	440.4	171.2
Net cash flow from investing activities	(470.0)	(467.0)	(457.4)	(376.2)	273.2
Net cash from from financing activities	(25.1)	38.1	26.5	(35.3)	(463.7)

2015 includes National Security Life and Annuity Co., whereas prior years do not.

Other Assessments

Overall, we consider ONFS' ERM and management and governance as neutral to the rating.

Enterprise risk management

ERM is of high importance to the rating, a revision from our prior assessment of low. ONFS has participated in the VA with living benefits market for more than a decade. The company has taken a number of steps to derisk the business, including its reinsurance agreement with ACE Tempest Life Reinsurance Ltd. in 2002, introduction of managed volatility funds in 2011, and its recent coinsurance agreement with CGT, a subsidiary of Wells Fargo NA. Despite these measures, we believe the retained risk from about \$12 billion of account value could expose ONFS to significant market volatility, especially given the relatively small size of its capital base. The account value associated with guaranteed living benefits was about \$12 billion as of year-end 2015, about 11x its reported statutory surplus at the end of 2015. Since we expect ONFS to continue selling VAs as part of its core strategy, we expect the account value to continue to grow.

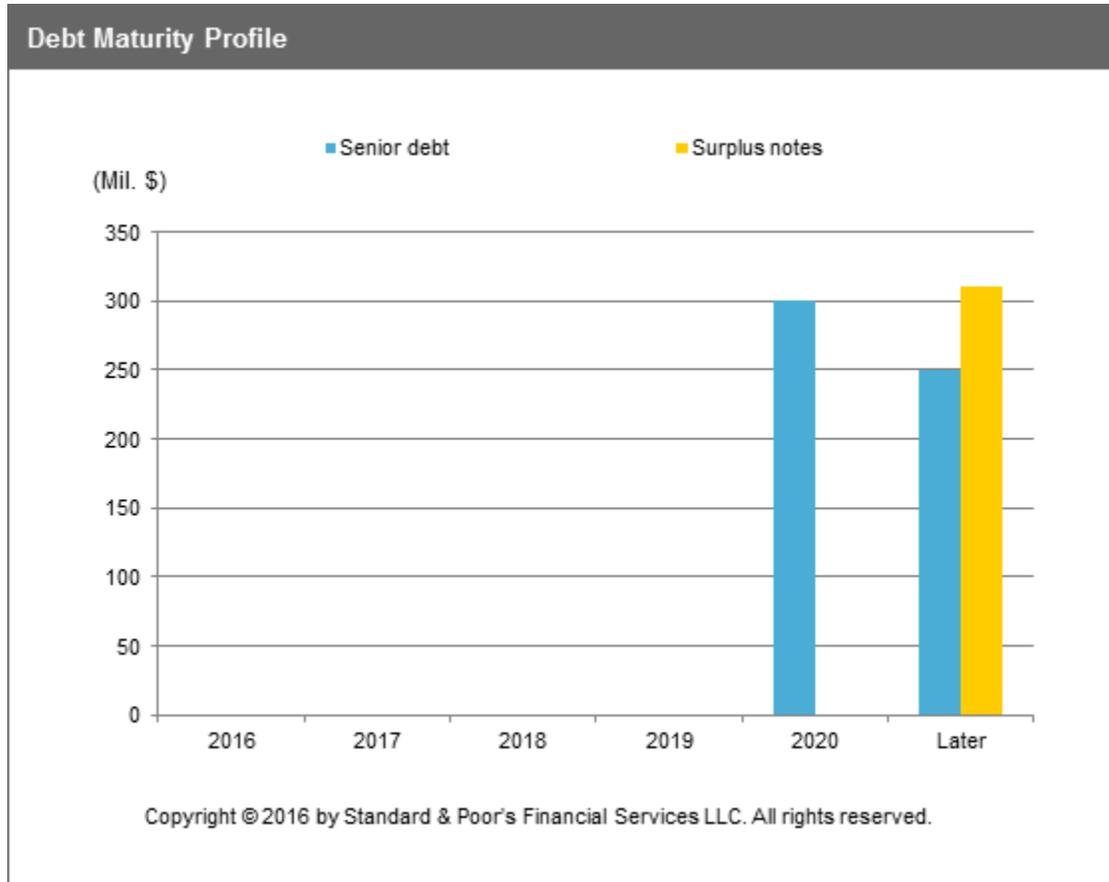
Our assessment of ERM as adequate reflects our neutral view of ONFS' risk-management culture, risk controls, and strategic risk management. In 2013, ONFS brought its VA hedging program in house. But we still view most of its controls for key risks as neutral since the company lacks strong risk controls in line with positively scored peers. In our opinion, ONFS' process for curing risk limit breaches is also less formalized than peers with strong risk controls. We consider ONFS' strict, no-exceptions mortality underwriting policy, which consistently generates favorable mortality and lapse experience relative to pricing, as one of its strongest areas of risk management.

Management and governance

We consider ONFS' management and governance as satisfactory. ONFS has a track record of strong execution, and was an early adopter of certain risk-mitigation strategies for its VA book, including managed volatility portfolio funds and coinsurance. By its own management operating earnings standards (internal measures that exclude the accounting "noise" arising from use of derivatives), ONFS has consistently achieved its operational goals. Sales growth is a top management focus, and ONFS has consistently been able to achieve y/y revenue growth. Its emphasis on expense controls, including managing part of its distribution system as a variable-cost platform, has led to operating efficiency and an ability to price products competitively. ONFS emphasizes product pricing that incorporates capital and asset-liability management in the design phase.

Liquidity

We consider ONFS' liquidity as strong. As of year-end 2015, its liquidity ratio was about 204%. The company had about \$11 million of confidence-sensitive liabilities as of year-end 2015 (less than 1% of liquid assets) at the holding company and no collateral-posting requirements.



Accounting Considerations

ONFS reports both statutory and audited GAAP bases. We assess its capitalization on a statutory basis, but use GAAP for fixed-charge coverage and leverage metrics. From a GAAP perspective, ONFS holds derivatives for hedging, and it has embedded derivatives in its liabilities. Its largest embedded derivative is the result of a reinsurance contract for its guaranteed living benefit riders written before 2008. Any movement in the value of this derivative flows through the income statement in the benefits and claims line. We typically adjust for this in our analysis, since any gain or loss in market value for this contract cannot be realized. The valuation of this embedded derivative is highly volatile and sensitive to both equity and interest rate movements.

Related Criteria And Research

- Treatment Of U.S. Life Insurance Reserves And Reserve Financing Transactions, March 12, 2015
- Methodology For The Classification And Treatment Of Insurance Companies' Operational Leverage, Oct. 31, 2014
- 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 Assessing Capital Charges For Commercial Mortgage Loans Held By U.S. Insurance Companies , May 31, 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 Model For U.S. And Canadian Life Insurers, April 22, 2004

Ratings Detail (As Of December 30, 2016)

Holding Company: Ohio National Financial Services Inc.

Issuer Credit Rating

Local Currency BBB+/Stable/--

Senior Unsecured

BBB+

Operating Companies Covered By This Report

Ohio National Life Insurance Co.

Financial Strength Rating

Local Currency A+/Stable/--

Counterparty Credit Rating

Local Currency A+/Stable/--

Subordinated

A-

Ohio National Life Assurance Corp.

Financial Strength Rating

Local Currency A+/Stable/--

Issuer Credit Rating

Local Currency A+/Stable/--

Domicile

Ohio

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' 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.

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