



Institute
and Faculty
of Actuaries

The UK Life Market in 2014 and Beyond – A Rating Agency Perspective

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Fitch Ratings

10 November 2014

Agenda

Credit Ratings

Capital in Ratings

Annuity Market Expectations

Other Market Themes

UK Life Sector Outlook

Q&A

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Credit Ratings

Purpose

Security / financial strength

Meaning

Probability of default / loss given default

Users

Investors

IFAs / policyholders

Actuaries

Implications

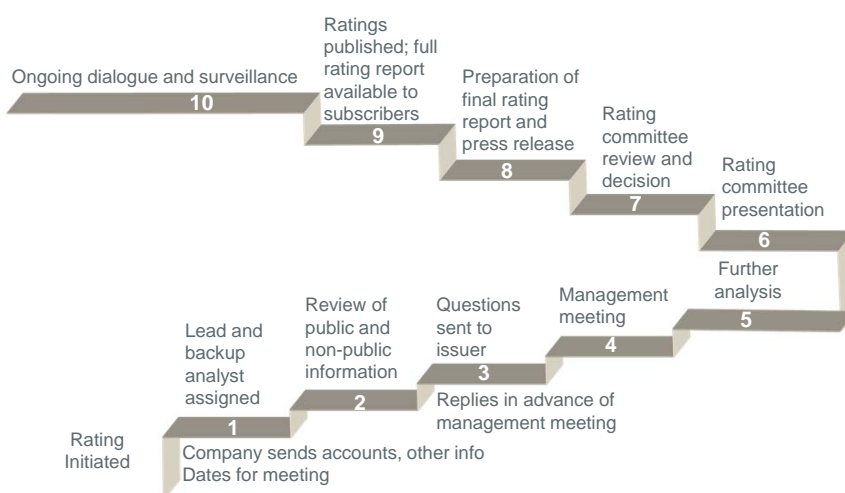
Cost of finance

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Steps in the Rating Process



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Insurance Rating Methodology

FitchRatings		Insurance	
Insurance Rating Methodology		Insurance / Global	
Global Master Criteria			
<p>This report describes the methodology used by Fitch Ratings to assign ratings to insurance companies. It is intended for use by investors, analysts, and other interested parties. The report is subject to change without notice.</p>			
<p>Table of Contents</p>			
<p>I. Key Credit Factors 4</p> <p>Key credit factors are those that influence the core fundamental credit analysis of insurance companies and groups. Includes discussion of how these key credit factors, as well as key financial ratios, relate to ratings levels.</p>			
<p>II. Weighting of Key Credit Factors in Final Rating 38</p> <p>General overview of how key credit factors are weighted in arriving at a final rating.</p>			
<p>III. Forward-Looking Elements 44</p> <p>Review of scenario analysis, credit ratings and forecasting, as well as "through the cycle" concepts. Also includes discussion of Rating Outlook/Watch Status.</p>			
<p>IV. Hybrid Securities: Treatment in Rating/Equity Credit 46</p> <p>Discusses treatment of hybrid securities in this analysis, including differences in the approach for capital adequacy ratios (including the impact of the regulatory treatment) and financial leverage ratios.</p>			
<p>V. Group Rating Methodology 54</p> <p>Reviews approach as to how the strengths and weaknesses within an organization affect the ratings of particular group members.</p>			
<p>VI. Reinsurance, Subsidiary, P/R Ratings, and Holding Companies 72</p> <p>Discusses the ratings used between issuer default ratings (IDR) and the ratings of individual debt and capital security issues, as well as issuer financial strength (IFS) ratings, and the ratings of operating and holding companies.</p>			
<p>VII. Stand-By and Stand-By Organizations 89</p> <p>Considers ratings for both newly formed companies, and those existing conditions.</p>			
<p>VIII. Short-Term Ratings 92</p> <p>Considers ratings in rating short-term instruments and derivatives, including consideration of how ratings compare and contrast with long-term ratings.</p>			
<p>IX. Recovery Analysis 94</p> <p>Discusses approach to estimate potential recovery rates for loss, nonperformance-grade and securities for which recovery ratings are assigned.</p>			
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<p>www.fitchratings.com September 4, 2014</p>			

Sector Credit Factor Reports



Capital – One of Twelve Credit Factors

Qualitative	Quantitative
Sovereign and country-related constraints	Capitalisation
Industry profile and operating leverage	Debt service capabilities and financial flexibility
Market position and size/scale	Financial performance and earnings
Ownership	Investment and asset risk
Corporate governance and management	Asset/liability and liquidity management
	Reserve adequacy
	Reinsurance, risk mitigation, and catastrophe risk

Scorecard Approach to Ratings

Credit Factor "Building Blocks" Scorecard (IFS Rating)								Non-Life/Health/Fide 2014		
Credit Factors	Historical Performance							Forward Trend	Score	Relative Weighting
	AAA	AA	A	BBB	<BBB	B	<B			
Industry Profile and Operating Environment	-	X	-	-	-	-	-	-	AA/A	Low
Market Position and Size/Scale <i>Market Position</i>	-	-	X	-	-	-	-	-	A	Moderate
Capitalization and Leverage	-	-	X	-	-	-	-	Steady	A	High
Debt Service Capabilities / Financial Flexibility <i>Financial/Fundable Adequacy</i>	-	-	X	-	-	-	-	Steady	A	Low
Financial Performance and Earnings	-	X	-	-	-	-	-	Steady	AA	High
Investment and Liquidity Risk	-	-	-	X	-	-	-	Steady	BBB	High
Reserve Adequacy	-	-	X	-	-	-	-	Steady	A	Moderate
Reinsurance / Risk Mitigation / Catastrophe	-	-	X	-	-	-	-	Steady	A	Moderate
Other / Non-insurance Attributes	-	-	-	-	-	-	-	-	-	-
Initial Implied Rating Category										A
Corporate Governance and Management				Effective		Some Weak Satisfaction				Neutral
Parent Name (only if applicable)				BBB	Neutral	Favorable / Inferiorable				Neutral
Ownership <i>(and Private Control if Substantial)</i>						Constitute Applicable?				Neutral
Start-Up / Runoff Status Constraints <i>(Sovereign)</i>						No				Neutral
Sovereign / Country-related Constraints <i>(Geographical)</i>						Constitute Applicable?				Neutral
Sovereign Rating (B,C)				BBB	Outlook	Stable				Neutral
Country Rating				AAA			No			
Final Implied Rating Category										A
Prepared By		Chris Williams				Type notes here (optional)				
Date Prepared		30-Sep-2014								

Fitch's Factor Based Capital Model

...Fitch's enhanced factor-based capital model

- Measure of insurers' capital strength
- Risk-based capital model
- Increased transparency
- Publicly available

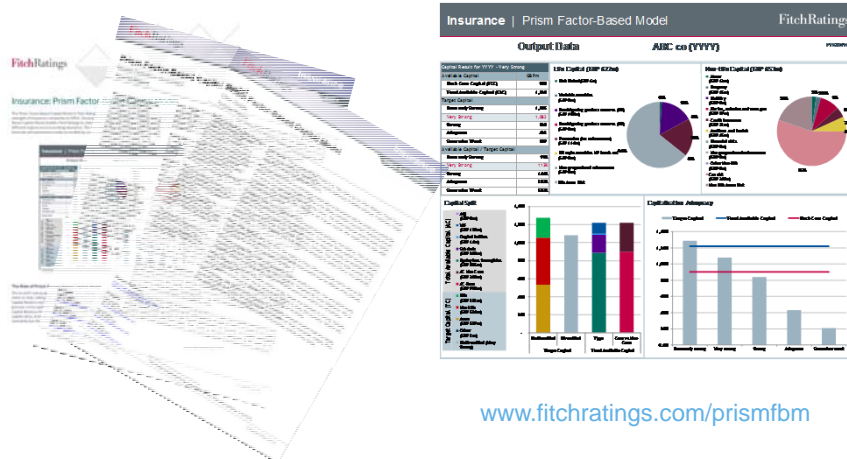
Download at: www.fitchratings.com/prismfbm

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Prism FBM Resources



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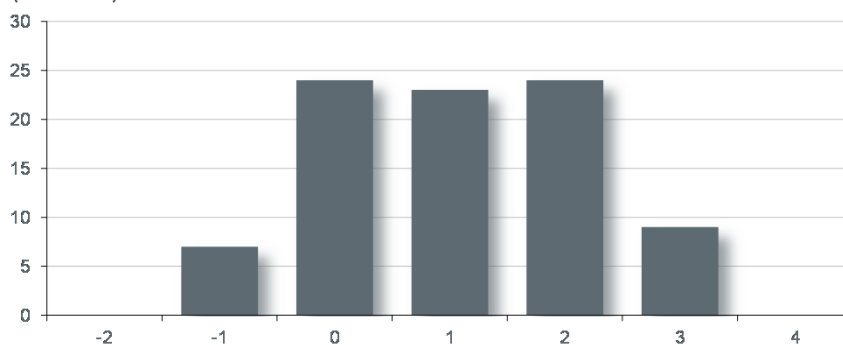
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Rated Portfolio Well Capitalised

Category Difference Between Prism FBM Score and Rating

(No. entities)



Source: Fitch

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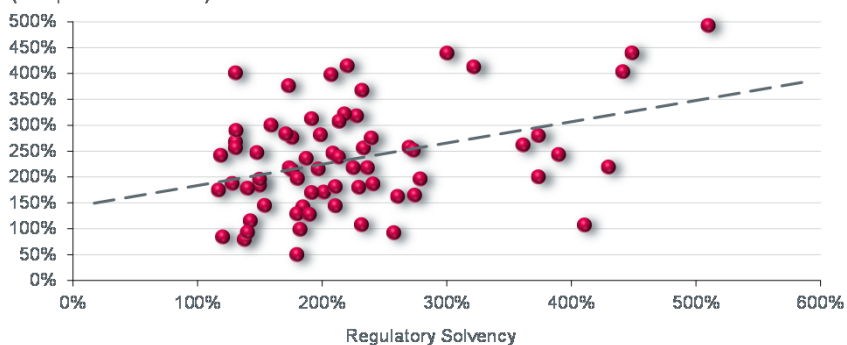
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Prism FBM Provides Risk Based View Of Capital

Average Prism FBM Score Versus Regulatory Capital Score

(Adequate Prism Score)



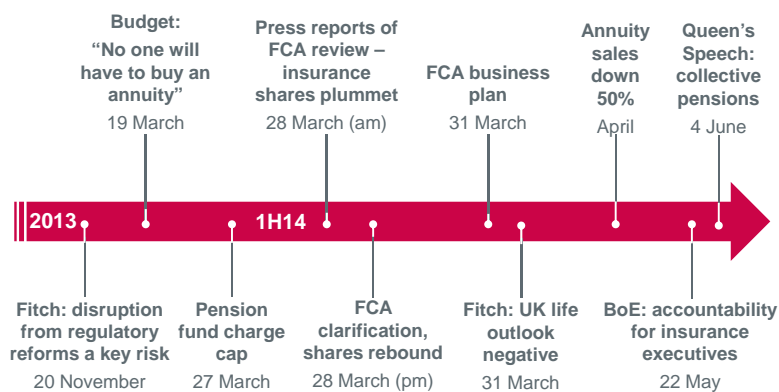
Source: Fitch, Companies

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UK Life – Timeline of 2014 Announcements



Source: Fitch

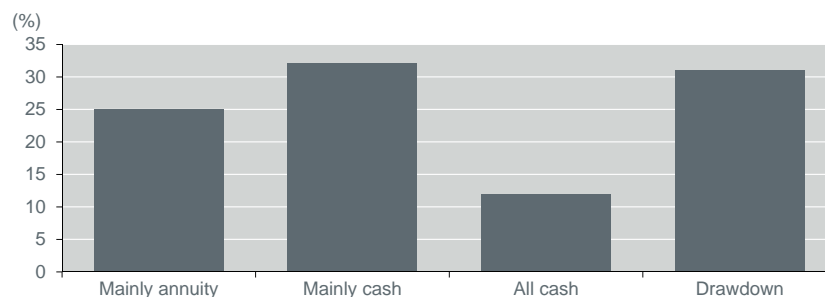
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Fitch Expects Annuity Sales to Decline 30-50%

Post-Budget Survey of How Retirees Plan to Use Pension Pots



Source: Hyman Robertson survey of 1,000 defined contribution pension scheme members, April 2014

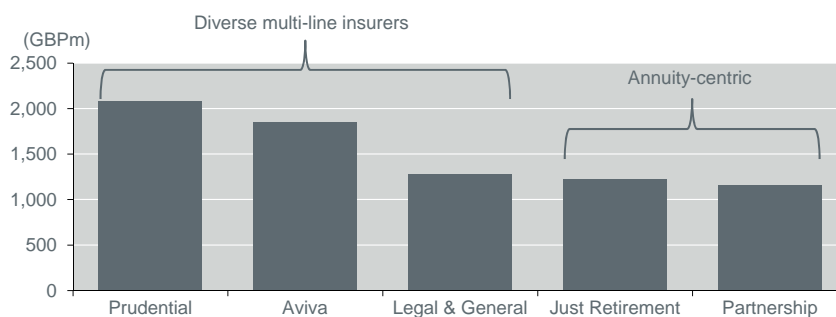
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Business Mix Determines Exposure to Annuity Decline

UK Individual Annuity Sales (2013)



Source: Companies

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Pensions Auto-Enrolment – Scale is Key

Positives

- Captures larger population
- Boosts AUM
- Cross-selling opportunity

Negatives

- Small amounts
- Low margin
- Low persistency



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Exposure to Low Bond Yields – Varies by Country

UK Life

- Product mix relatively immune
- Annuities well matched
- With-profits flexible

Dutch Life

- ALM strong – good matching / hedging
- Low yields exacerbate new business decline

German Life

- High proportion of guaranteed business
- Significant duration gaps
- Rated insurers can meet guarantees for 10+ years

French Life

- Guarantees not onerous

Italian Life

- Issue is sovereign risk, not low yields

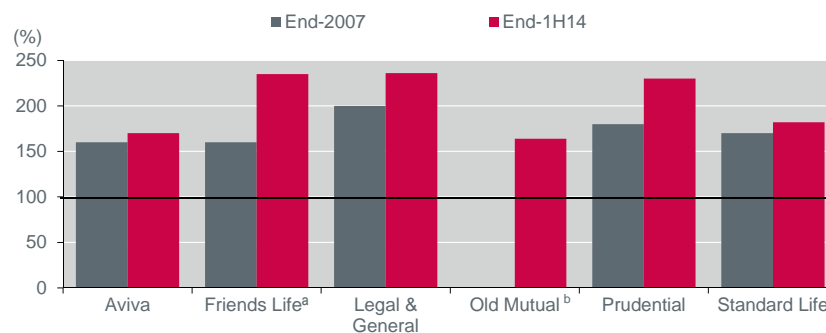
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Capital Above Pre-Crisis Levels

Regulatory Solvency Ratio



^a End-2007 data is for predecessor company, Friends Provident

^b Not published for end-2007

Source: Companies

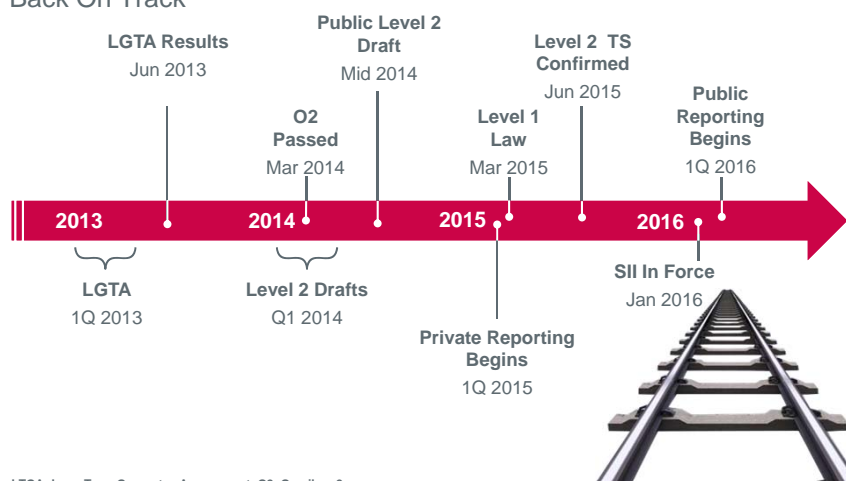
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Solvency II – Timeline to Implementation

Back On Track



LTGA: Long Term Guarantee Assessment; O2: Omnibus 2

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Solvency II – Predictions...

- Solvency ratios to go down but....
...surplus capital to go up
- Internal models to reduce capital requirements
- Equivalence for US

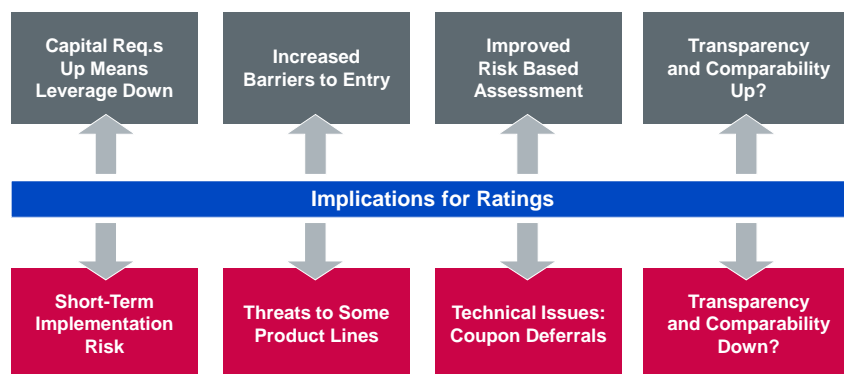


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Solvency II – Implications for Ratings – Neutral



Globally Systemically Important Insurers (GSIs)

9 insurers designated GSIs:

- 2 in UK – Aviva, Prudential

Extra regulation

Extra capital:

- Non-traditional business
 - eg US variable annuities
- 2019+?

Competitive disadvantage

Individual countries may mirror GSI standards

See Fitch comment

FitchRatings

FITCH: GSI BASIC CAPITAL LEAVES ROOM FOR SIGNIFICANT VARIATION

Fitch Ratings-London-24 October 2014: The relatively low basic capital requirements for globally systemically important insurers (G-SIIs) suggests those with traditional business models may face little increase in total capital requirements when the full regime is implemented, while the rise for those with non-traditional operations could be much larger, Fitch Ratings says.

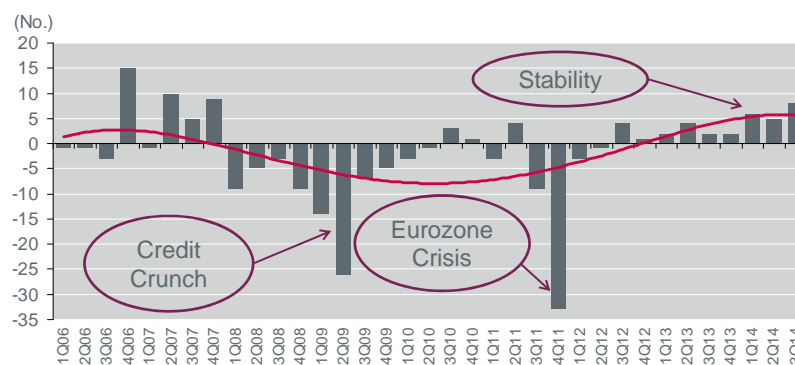
The basic capital requirements (BCR), details of which were announced yesterday, are the first step in a process to develop global capital standards for G-SIIs. From 2019, these insurers will have to hold capital of at least the BCR, plus a higher-loss-absorption (HLA) requirement. The International Association of Insurance Supervisors has set the BCR at a relatively low level, equivalent to 75% of the average capital requirement for G-SIIs under existing rules in their home market. But the HLA will not be finalised until late 2015, so the final overall impact is uncertain.

We expect the HLA to focus more on risk than just size, potentially imposing tougher standards on things like credit default protection, variable annuities and newer product lines with shorter pricing and performance track records. The higher potential risk of these non-traditional products is already factored into our ratings, as demonstrated by our downgrade of Prudential Plc in 2010, which was partly driven by the rapid growth in variable annuity business at its Jackson National Life subsidiary.

Even if the BCR and HLA combined do significantly increase the total minimum capital requirement for some G-SIIs, we do not expect any insurers to breach the requirements or to have to raise fresh

Affirmations Predominate

Net Upgrades Less Downgrades

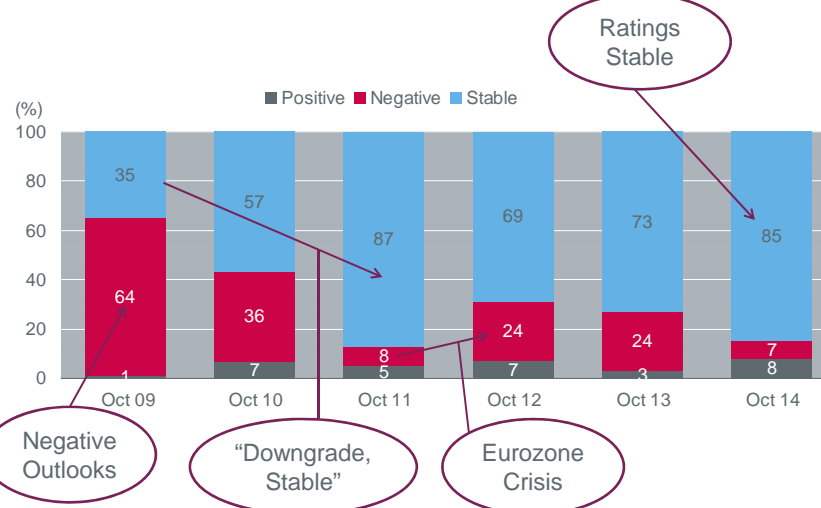


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Outlooks / Watches Stabilise



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UK Life Ratings

Company	IFS rating ^a	Outlook/watch
Prudential	AA	Stable
Legal & General	AA-	Stable
Scottish Equitable	AA-	Stable
Friends Life	A+	Stable
Scottish Widows	A+	Negative
Old Mutual	A-	Stable

^a Insurer Financial Strength Rating of main operating company
 Note: Ratings as at 28 October 2014
 Source: Fitch

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Predictions for the Market – 2015 and Beyond

Products

- Shift from annuities to simple drawdown
- Collective pensions will not take off

Distribution

- Shift to restricted / no advice
- Persistency improves
- Digital

Market Trends

- Cost cutting
- Pension risk transfer to insurers
- Access to capital



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Fundamentals Negative on Balance

Negatives

- Annuity decline
- Regulation intensifying
- Low investment yields
- Pricing competition
- Net outflows



Partially Offset By...

- Strong capital
- Relatively immune to low yields
- Better management discipline
 - Cost control
 - Product mix
 - Pricing
- Overseas earnings

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What Insurers May Not Want You to Know

The whole truth:

- Headlines always good
- Operating / underlying performance
- “Good results = good management, bad results = markets”
- Modelling “adjustments”
- Lapses / surrenders / outflows – hidden behind sales figures

Solvency II:

- Not ready
- Worst-case impacts

Capital / M&A strategy

- “Delighted to have sold our acquisition”

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Some Things We've Heard

"... ill thought-out EU legislation endangering a great British business that should have its HQ right here in the UK"

"S2 is unfathomable – you're dealing with all these Europeans"

"Force feeding government debt to financial institutions through regulation – allows the government to fund the deficit cheaply"

"The Spanish are happy – they're buying 'risk free' govies yielding 6%"

"If we were to redomicle you'd be turning out the lights in the City – everyone else would have left first"

"S2 LTGP is just a nonsense, an utter nonsense. The results were rubbish"

"RDR – the industry couldn't behave itself. Systematically throwing capital at intermediaries"

"Government bonds = return-free risk"

"Trying to prepare for S2 is like trying to nail jelly to the ceiling"

"We won't get out of this cycle without a credit event. That's why we're keeping the credit reserve"

"S2 will bring volatility. We all knew that from the beginning. Let's not be naive"

"Most funds are in the bottom quartile"

"Insurers don't go bust – they can 'make up' their liabilities"





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Invitation – Save the Date

Please join us at Fitch's European Insurance Roadshow

Thursday 22 January 2015, London



Ask the presenters or check for details at www.fitchratings.com/events



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If You Want to Know More...

Find these and more on insurance at www.fitchratings.com/insurance

- EU Parliament Vote Ensures Solvency II On Track for 2016 – March 2014
- UK Budget Proposals Negative for Annuity Providers – March 2014
- Bulk Annuities To Help Insurers Handle UK Pension Change – March 2014
- UK Life Outlook Negative – March 2014
- Low Rates Largely Behind UK Annuity Sales Drop - For Now – May 2014
- BoE Underlines Growing Regulatory Scrutiny of UK Insurers – May 2014
- Collective UK Pensions Pose Fresh Challenges for Insurers – June 2014
- UK Life Insurance Dashboard 1H14 – August 2014
- Insurance Rating Methodology – 4 September 2014

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Questions

Comments

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