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The UK Life Market in 2013 and Beyond – A Rating Agency Perspective

David Prowse & Clara Hughes
Fitch Ratings

11 November 2013

Agenda

Credit Ratings

UK Life Market – Metrics

Market Developments

Looking Ahead

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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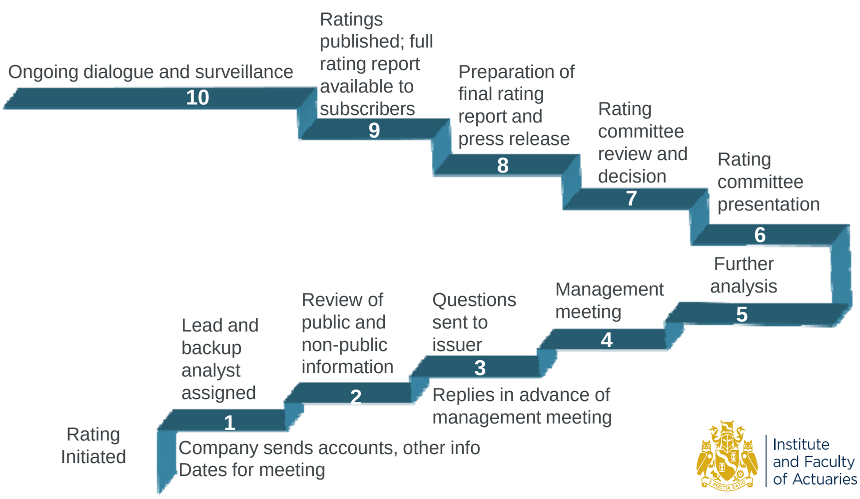
Steps in the Rating Process



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Rating Factors – Overview

Rating Factor	Forward Trend	Score	Relative Weighting
Industry Profile and Operating Environment		AA/A	Moderate
Market Position and Size / Scale		AA	High
Capitalisation and Leverage	Stable	A	High
Debt Service Capabilities / Financial Flexibility	Favourable	BBB	Moderate
Financial Performance and Earnings	Unfavourable	A	Moderate
Investment and Asset Risk	Stable	AA	Moderate
Asset / Liability and Liquidity Management	Stable	AA	Low
Reinsurance / Risk Mitigation	Stable	AA	Low
Corporate Governance and Management		Effective	
Ownership		Neutral	
Start-Up / Run-Off Status Constraints		n/a	
Sovereign / Country-Related Constraints		n/a	

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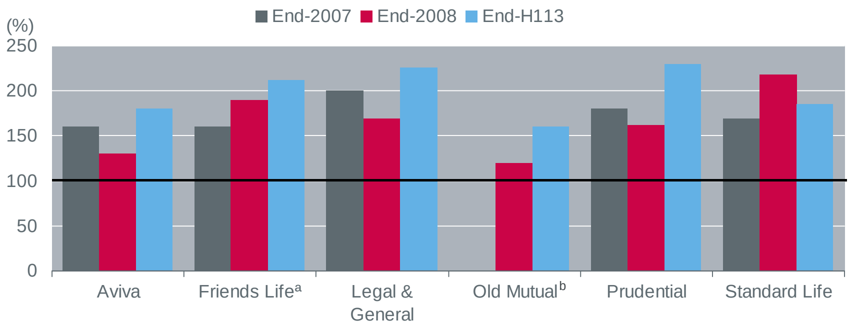
Capital Above Pre-Crisis Levels

Regulatory Solvency Ratio



[a] End-2007 and end-2008 data is for predecessor company, Friends Provident
[b] Not published for end-2007
Source: Companies

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Earnings – EV vs IFRS

- I(?!)FRS …
- IFRS for group balance sheet and cashflow
- EV for long-term value
- MCEV → inconsistency
- EV in credit analysis
  - Long-term profitability (VIF, VNB)
  - Risks, profit drivers
  - Adjust IFRS balance sheet to give credit for VIF

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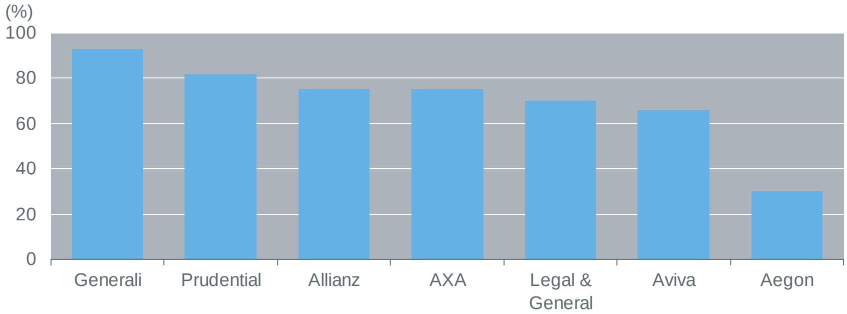
Insurers Trading at Discount

Market Capitalisation to Embedded Value (2011)



Based on 2011 data as Aegon did not publish 2012 embedded value
Source: Fitch, companies

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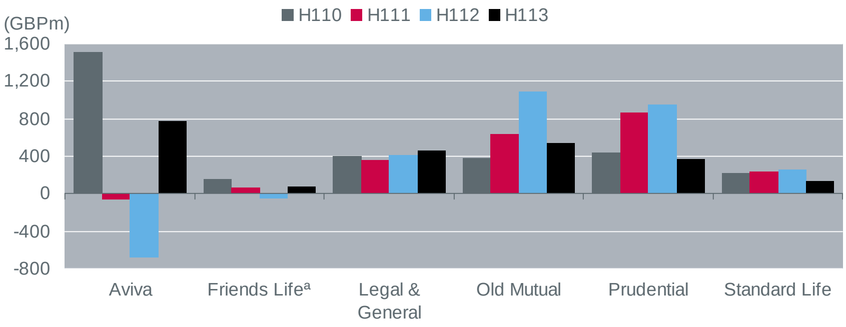
Earnings Mixed

IFRS Net Income



[a] H110 data is for predecessor company, Friends Provident
Source: Companies

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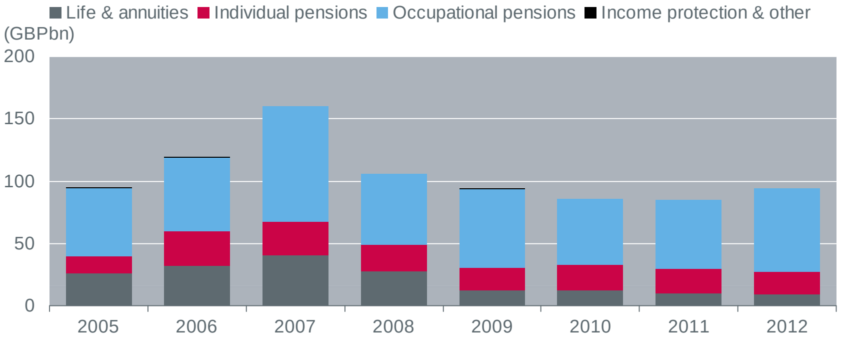
Sales Still Subdued

Single Premium



Source: ABI

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Profits and Sales Under Threat

Threats to earnings

- Low interest rates
- Defensive investments
- Net outflows

Threats to sales

- Disposable income squeezed
- Consumer deleverage
- Slow housing market

Responses

- Cost-cutting
- Low-cost distribution
- Consolidation
- Overseas earnings

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Predictions for H2 2013 Results

Positives

- Capital stable
- Resilience to eurozone

Negatives

- Earnings subdued
- Sales flat

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S2 – Watered Down

Transitional Arrangements

2016 ? → 2026+?

Predictions

- Phase 1 (easy bits) first, Phase 2 (controversial bits) later – see IFRS
- ~~European harmonisation~~
- Capital requirements up … a bit
- Asset allocation will shift … a bit
- Equivalence – yes, in effect
- Credit ratings – unaffected for several years

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Globally Systemically Important Insurers (GSIIs)

9 insurers designated GSIIs:

- 2 in UK – Aviva, Prudential

Extra regulation

Extra capital:

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

Competitive disadvantage

Individual countries may mirror GSII standards

See Fitch comment

FitchRatings

FITCH: CAPITAL GAIN TO OFFSET COMPETITION IMPACT IN GSII RATINGS

Fitch Ratings-London-19 July 2013: Insurers included on the Financial Stability Board's list of global systemically important insurers could see a modest improvement in their credit profiles due to the higher risk and capital management standards imposed on them, Fitch Ratings says. However, these insurers' ratings are already high, with little room to improve, and the benefit could be diminished if the extra capital they have to hold for specific products makes them less competitive and damages their market position.

The list published on July 18, 2013 names nine insurers as globally important, listed below. These firms' ratings are already supported by strong capital levels and ratings are more likely to be limited by earnings power and market position than by capital adequacy. However, some insurers do have high debt leverage, which could be reduced by any additional capital they may have to hold. The requirement that GSIIs create a recovery and resolution plan implies governments are less likely to bail out insurers in the future, but this will not affect our ratings because we do not factor in any potential government support.

The decision to apply extra capital requirements only to non-traditional insurance business indicates a focus on risk, rather than just size, and is in line with the approach underlying our ratings. This also limits the impact that the GSII requirements will have on balance sheets, especially as few large insurers any longer underwrite credit default protection products such as those that got AIG Financial Products into trouble. However other products, potentially including variable annuities,

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Low Yields – UK Life Less Exposed

Long-term investment guarantees

Duration mismatch:

- Reinvestment / future regular premiums
- Primarily continental issue, eg Germany
- UK product mix less affected

New business at risk:

- Prediction – more closed funds / run-offs

Search for yield:

- Insurers can benefit from illiquidity premium
  - Subject to S2, internal models
- From de-risking to re-risking – “dash for trash”

See Fitch comment

FitchRatings

Fitch: Low Rates May Threaten EU Life Insurers' Business Models Endorsement Policy
13 Mar 2013 6:51 AM (EDT)

Fitch Ratings-London-13 March 2013: Prolonged low interest rates in Europe would threaten the viability of savings products with investment guarantees, traditionally a fundamental part of many life insurers' business models, Fitch Ratings says. The impact of low rates was highlighted as a key concern recently when the European Insurance and Occupational Pensions Authority called for feedback from local regulators on the scale of the risk.

The investment guarantees that insurers can offer to new customers are driven by the yields on the bonds that they can invest in. Low yields make these products unattractive to customers, hitting sales volumes and potentially making the business unviable. Some insurers have told us that they plan to shift their business towards protection products and annuities, where profits are driven by pricing for insurance risks, rather than by financial markets.

A prolonged slowdown in sales could also make insurers' existing books of guaranteed-return business increasingly uneconomical as declining books become insufficient to support their fixed costs. Ultimately, insurers are likely to put the legacy business into run-off in closed funds, which they may then offload to consolidators. We expect further consolidation of closed with-profits funds in the UK and significant closed-fund consolidation in the Netherlands, where there has been a dramatic fall in insurers' savings business due to tax changes that allowed banks to compete on equal terms with insurers.

A prolonged period of low interest rates would also hurt life insurers by cutting the returns available when they reinvest assets backing their existing guaranteed-return business. However, this impact would vary significantly depending on how closely they have matched the duration of their assets and liabilities. Insurers often hold assets with a shorter

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UK Life Insurers Taking Gender Ruling in Stride

See Fitch comment

FitchRatings

FITCH: UK LIFE INSURERS TO TAKE GENDER RULING IN STRIDE

Fitch Ratings-London-28 June 2012: Fitch Ratings expects UK life insurers to face no serious impacts to their business when they adapt their pricing to comply with the European Court of Justice ruling on gender-neutral insurance premiums. The agency believes that insurers have the necessary underwriting and pricing expertise to maintain profitability as they adjust to the new requirements. Fitch does not envisage any changes to insurers' credit ratings driven by the consequences of the ruling.

From 21 December 2012, insurers will no longer be allowed to charge different premium rates based on gender. This has the potential to distort pricing, introducing cross-subsidies between the genders, most notably in the annuity market (GBP10-15bn of new business a year) and life protection market (around GBP1bn a year).

"Mortality/longevity is the main risk in these markets, and insurers set their prices to reflect the risk for each policyholder," says David Prowse, Senior Director in Fitch's Insurance team. "They currently use gender as one of their main pricing factors, given the proven link between gender and mortality. Annuity rates, for example, differ by around 10% between the genders, with women paying more to reflect their longer life expectancy. However, as a consequence of the gender ruling, annuity rates look set to fall for men and rise for women. In contrast, men may get a better deal on protection, at the expense of women."

Insurers will now place more weight on other factors such as age and health, when pricing their business. However, Fitch expects the impact of this to be limited because age and health are already more significant pricing factors than gender, as they are stronger indicators of mortality.

Premium/annuity rates for joint-life business are unlikely to change significantly as a result of the ruling, as they typically cover one life of each gender. Most annuity business and a significant proportion of protection business is joint-life.

Annuity/premium rates vary significantly between competitors as they manoeuvre in response to market conditions and tactical positioning. Pricing impacts from the gender ruling could be blurred

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RDR – A Step-Change in Distribution

~~Commission~~

See Fitch report


FitchRatings Insurance
Life Insurers / United Kingdom

UK Life Insurance Retail Distribution Review

No Immediate Rating Impact, but Potential for Long-Term Effects

Special Report

No Immediate Rating Impact: Fitch does not expect any immediate impact on UK life insurer ratings from the Financial Service Authority's (FSA) retail distribution review (RDR). However, companies highly reliant on IFA distribution networks could eventually be negatively affected, while companies able to focus on platform or bancassurance sales may be positively affected.

Shift Away from IFAs: Fitch expects a move towards cheaper simplified advice, basic advice or no advice at all. There is likely to be some short-term disruption as advisers and consumers adapt to the new rules. Products that are primarily distributed via independent financial advisers (IFAs), such as individual pensions, are likely to be most affected. The agency forecasts a contraction in the IFA market, and consolidation among adviser firms. However, Fitch believes that IFAs will remain the dominant sales channel.

Increase in Platforms' Popularity: Platforms are a user-friendly way for IFAs to service their clients, and so Fitch expects them to become increasingly used. There is also potential for more sophisticated mass-market consumers to make use of platforms to buy and manage products directly.

Growth in Bancassurance: Fitch believes that RDR will provide an opportunity for bancassurers to take market share. Consequently, Fitch expects some banks to invest more in their financial advice services.

Exclusion of Mass Market: Fitch believes that the RDR could create an advice gap.

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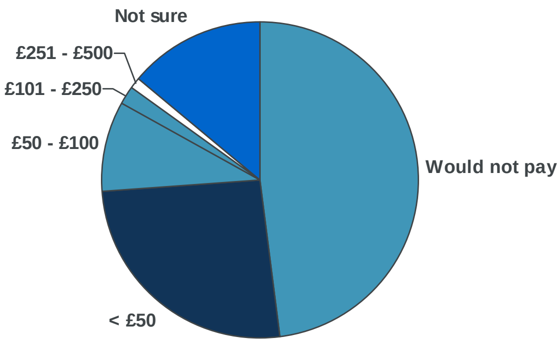
RDR … "If you were required to pay a fee for advice, how much would you be willing to pay?"



Source: ABI Quarterly Consumer Survey Q3 2011

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Pensions Auto-Enrolment – Prospects Limited

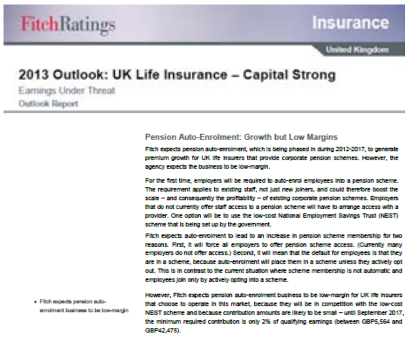
Positives

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

Negatives

- Small amounts
- Low margin
- Low persistency

See Fitch report



FitchRatings Insurance

United Kingdom

2013 Outlook: UK Life Insurance – Capital Strong

Earnings Under Threat

Outlook Report

Pension Auto-Enrolment: Growth but Low Margins

Fitch expects pension auto-enrolment, which is being phased in during 2012-2017, to generate premium growth for UK life insurers that provide corporate pension schemes. However, the agency expects the business to be low-margin.

For the first time, employers will be required to auto-enrol employees into a pension scheme. The requirement applies to existing staff, not just new joiners, and could therefore boost the scale – and consequently the profitability – of existing corporate pension schemes. Employers that do not currently offer staff access to a pension scheme will have to arrange access with a provider. One option will be to use the low-cost National Employment Savings Trust (NEST) scheme that is being set up by the government.

Fitch expects auto-enrolment to lead to an increase in pension scheme membership for two reasons. First, it will force all employers to offer pension scheme access. (Currently many employers do not offer access.) Second, it will mean that the default for employees is that they are in a scheme, because auto-enrolment will place them in a scheme unless they actively opt out. This is in contrast to the current situation where scheme membership is not automatic and employees join only by actively opting into a scheme.

- Fitch expects pension auto-enrolment business to be low-margin

However, Fitch expects pension auto-enrolment business to be low-margin for UK life insurers that choose to operate in this market, because they will be in competition with the low-cost NEST scheme and because contribution amounts are likely to be small – until September 2017, the minimum required contribution is only 2% of qualifying earnings (between GBP5,564 and GBP42,475).

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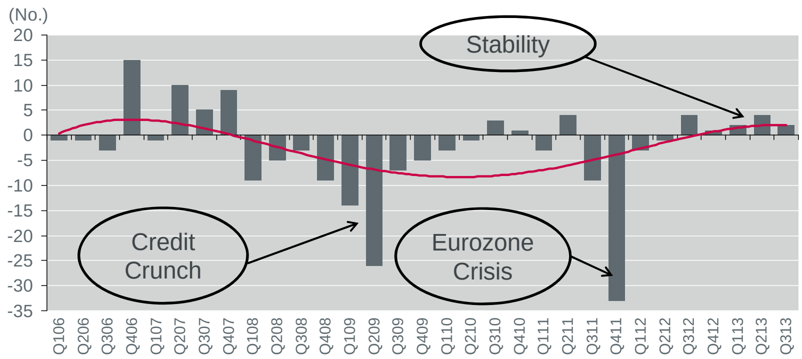
Affirmations Predominate

Net Upgrades Less Downgrades



Source: Fitch

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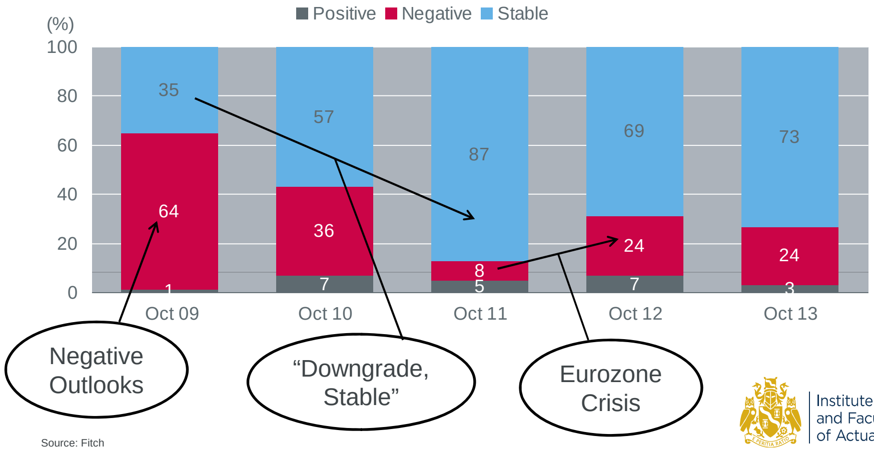
Outlooks / Watches Stabilise …
But North-South Divide Opens Up



Source: Fitch

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UK Life Ratings

Company	IFS rating[a]	Outlook/watch	Change since end-2007
Prudential	AA	Stable	-1
Legal & General	AA-	Stable	-2
Friends Life	A+	Stable	0
Scottish Widows	A+	Stable	-2
Old Mutual	A-	Stable	-2

[a] Insurer Financial Strength Rating of main operating company
Note: Ratings as at 30 October 2013
Source: Fitch

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UK Life Sector Rating Outlook = Stable

Fitch's View on UK Life Insurers

	Performance	Outlook
Capital & leverage		→
Financial performance & earnings		↗
Asset / liability & liquidity management		→
Regulatory changes		→

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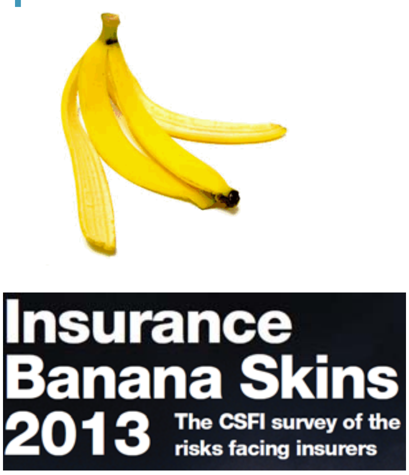
Top 10 Risks for Life Insurers



Rank	Risk
1	Regulation
2	Macro-economic environment
3	Guaranteed products
4	Investment performance
5	Business practices
6	Distribution channels
7	Reputation
8	Quality of management
9	Political interference
10	Quality of risk management

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Predictions for 2014+

Distribution

- IFA sales fall
- Direct sales rise
- Persistency improves

Products

- Savings get simpler

Regulatory / financial reporting

- S2 gets (more) political
- MCEV remains on hold
- IFRS Phase 2 heralds (more) confusion
- M&A sparked by low margins, S2, war chests

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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
- Sensitivity to credit markets
- S2:
  - Not ready
  - Worst-case impacts
- Capital / M&A strategy ("delighted to have sold our acquisition")

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Some Things We've Heard

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

"… 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"

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

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

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

"Government bonds = return-free risk"

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

"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"

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

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

"Most funds are in the bottom quartile"

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Related Research (www.fitchratings.com)

- UK Life Insurers Upbeat; Ratings Outlook Stable, 14 Aug 2013
- Capital Gain to Offset Competition Impact in GSII Ratings, 19 Jul 2013
- New Solvency II Proposals Will Not Settle Old Arguments, 17 Jun 2013
- Life Insurance (Europe) Sector Credit Factors, 2 May 2013
- 2013 Outlook: UK Life Insurance – Capital Strong, 6 Sep 2012
- Fitch: UK Life Insurers to Take Gender Ruling in Stride – Jun 2012
- UK Life Insurers Sheltered from Eurozone Peripherals – Mar 2012
- UK Life Insurance Retail Distribution Review, 26 Sep 2011
- Embedded Value - Valuable, But More Consistency Needed, Dec 2009

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Questions **Comments**

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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