

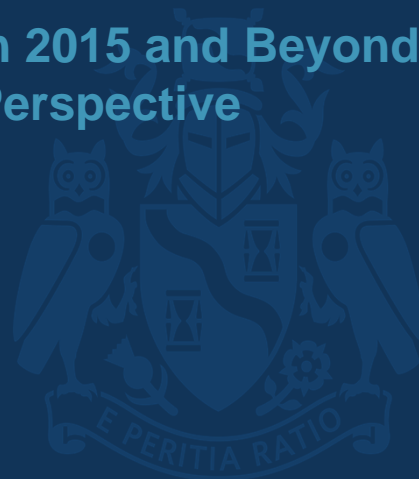


Institute
and Faculty
of Actuaries

The UK Life Market in 2015 and Beyond – A Rating Agency Perspective

David Prowse & Harish Gohil
Fitch Ratings

20 November 2015



Agenda

Credit Ratings

Capital in Ratings

Solvency II

Market Themes

UK Life Sector Outlook

Q&A

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Credit Ratings – What and Why

Purpose

Security / financial strength

Meaning

Probability of default / loss given default

Users

Investors

IFAs / policyholders

Actuaries

Implications

Cost of finance

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Insurance Ratings – One Simple Document

FitchRatings		Insurance	
Insurance Rating Methodology		Insurance - Global	
Global Master Criteria			
Table of Contents			
<p>I. Key Credit Factors 4</p> <p>Key elements of criteria 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 rating levels.</p> <p>II. Weighting of Key Credit Factors in Final Rating 38</p> <p>General overview of how key credit factors are assigned in setting a final rating.</p> <p>III. Forward-Looking Elements 44</p> <p>Review of sensitivity analysis, stress testing and forecasting, as well as "through the cycle" scenarios, also includes discussion of Rating Outlook/Future Outlook.</p> <p>IV. Hybrid Securities: Treatment in Rating/Eligible Credit 48</p> <p>Discussion treatment of hybrid securities in rating process, including references to the approach for capital adequacy ratios (showing the impact of the regulatory overlay) and financial strength ratios.</p> <p>V. Group Rating Methodology 54</p> <p>Addressed issues do to how the strengths and weaknesses within an organization affect the ratings of particular group members.</p> <p>VI. Reinsurance, Debt, Hybrid, d/s Ratings, and Holding Companies 73</p> <p>Discusses the ratings used for reinsurance and debt (including d/s), and the ratings of individual debt and equity security issues, as well as the financial strength (FS) ratings, and the ratings of operating and holding companies.</p> <p>VII. Start-Up and Runoff Organizations 89</p> <p>Considerations for start-up and runoff companies, and their rating transitions.</p> <p>VIII. Short-Term Ratings 92</p> <p>Considerations in rating short-term instruments and obligations, including consideration of short-term ratings and short-term ratings scales.</p> <p>IX. Recovery Analysis 94</p> <p>Methodology used to estimate potential recovery rates for non-reinsurers/holders and scenarios for short-term ratings are assigned.</p> <p>X. Capital Insurance Companies 102</p> <p>Discussion ratings of capital insurance companies, including quantitative rating triggers and other considerations for private ratings of capital.</p> <p>XI. Additional Considerations 107</p> <p>A. Types of Insurance Ratings 108</p> <p>B. Interim/Supervisory Ratings 110</p> <p>C. Considerations of Criteria 112</p> <p>D. Exceptions to Master Criteria 114</p>			
www.fitchratings.com		September 8, 2014	

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How We Apply Rating Methodology



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Main Rating Factors for Life Insurers

Main Qualitative Factors

- Sovereign and country-related constraints
- Industry profile and operating environment
- Market position and size/scale
- Ownership
- Corporate governance

Main Quantitative Factors

- Capitalisation and leverage
- Debt service capabilities and financial flexibility
- Financial performance and earnings
- Investment and asset risk
- Asset/liability and liquidity management

Source: Fitch - Insurance Rating Methodology, 16 September 2015

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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

Source: Fitch - Insurance Rating Methodology, 16 September 2015

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Fitch's Prism Capital Model

Factor-based capital model

- Measure of insurers' capital strength
- Risk-based capital model
- Comparable across different markets
- Transparent
- Publicly available

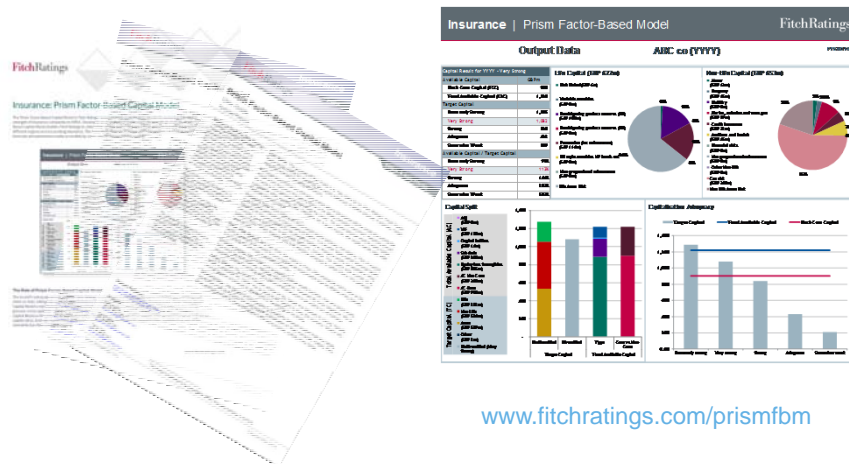
Download at: www.fitchratings.com/prismfbm

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Fitch Assessment of Capital Strength: Prism FBM



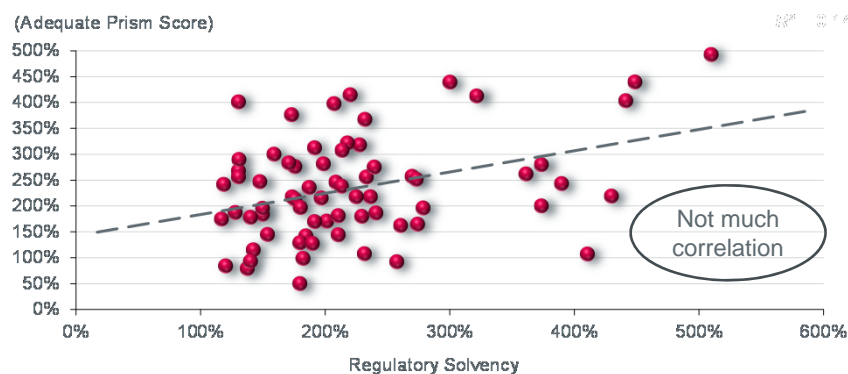
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Prism FBM Provides Risk-Based View Of Capital

Average Prism FBM Score Versus Regulatory Capital Score



Source: Fitch, companies

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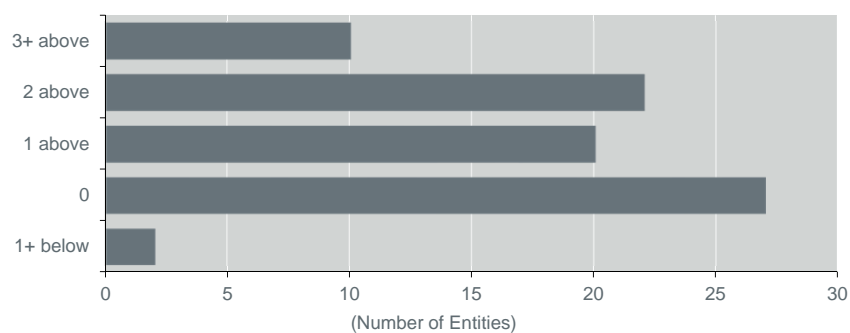
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Rated Portfolio Well Capitalised vs Ratings

Prism Score vs IFS Rating

Category Difference for EMEA at end-2014



Source: Fitch

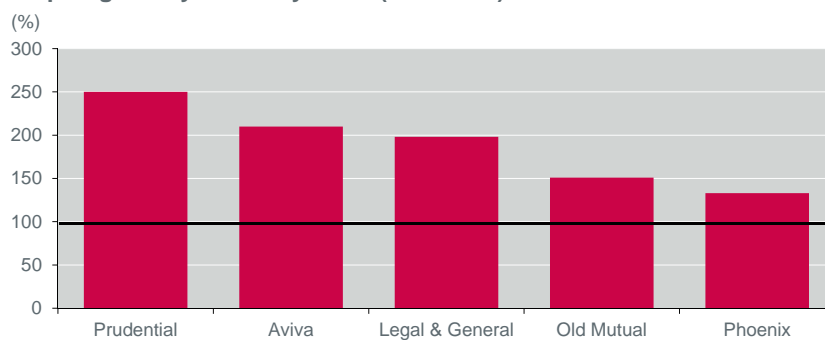
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Strong Resilient Balance Sheets

Group Regulatory Solvency Ratio (End-1H15)



Source: Companies

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days...

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Solvency II Predictions...

Nearly all insurers solvent (in contrast to QISs)

Asset and product mixes will shift gradually

M&A – more in 2016

Playing field NOT level

Internal models will reduce capital requirements

Cautious submissions in 2015, more aggressive in 2016

Market focus on SCR coverage – with and without transitionals

Feb/Mar 2016 – market will punish insurers that fall below expectations

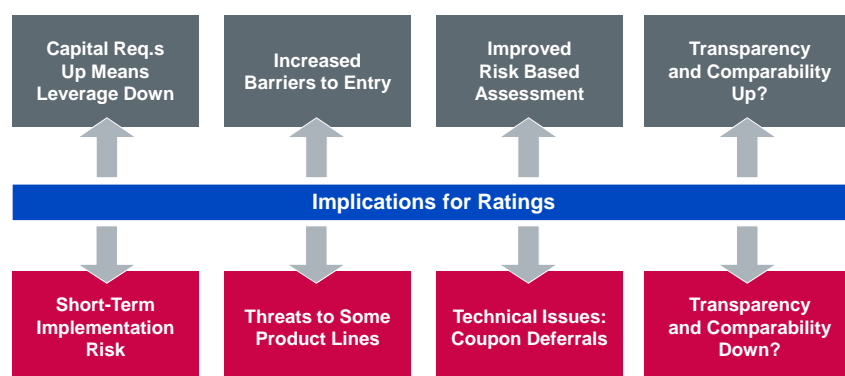


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Solvency II Implications for Ratings – Neutral



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Solvency II Unlikely to Change Ratings

Unlikely to transform major life insurers' balance sheets in near term

Unlikely to change ratings in near term

Key caveat:

- Results remain subject to regulatory approval, but...
- ...transitionals give breathing space

Fitch's capital assessment will continue to be driven by Prism FBM

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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

2015 – Aegon on, Generali off

See Fitch comments

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FITCH: GSI LIST PUTS INSURERS' BUSINESS STRATEGY IN SPOTLIGHT

Fitch Ratings-London-03 November 2015: A change to the list of globally systemically important insurers (G-SIs) suggests the potential for being added to or removed from the list could play a significant role in setting strategy for some major insurers, Fitch Ratings says.

The list was first published in 2013 and was unchanged last year, but on Tuesday the Financial Stability Board (FSB) removed Generali and added Aegon. The FSB did not explain why it made the switch, but we believe it could have been driven by changes in both firms' exposure to non-traditional and non-insurance business.

Generali in September sold its Swiss private banking arm BSI to BTG Pactual in a deal that significantly reduced its exposure to banking. At the same time, Aegon has increased its exposure to variable annuities, a non-traditional product with embedded options and guarantees that we believe give rise to risks that are complex, long-tailed, and difficult to price, hedge and reserve for.

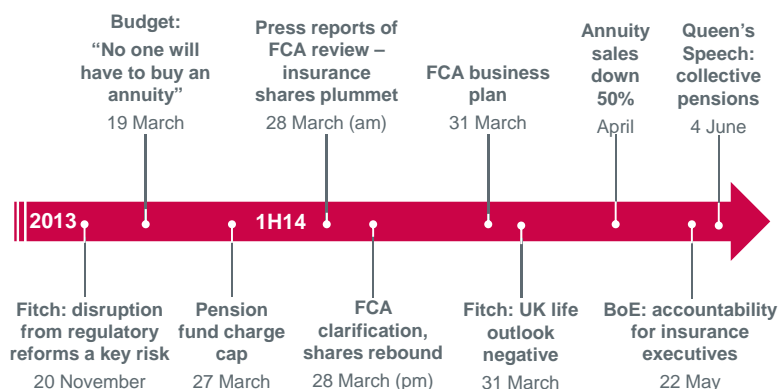
Inclusion on the list means having to hold more capital, face closer regulatory scrutiny and develop recovery and resolution plans. While higher capital is overall positive for insurers' credit profiles,

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UK Life – Timeline of 2014 Announcements



Source: Fitch

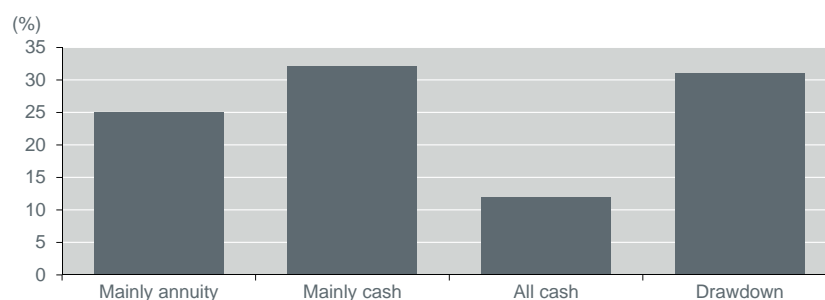
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Fitch Expected Annuity Sales to Decline 30-50% (And We Still Do)

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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Annuities Sales Fell Sharply After March 2014 Budget

Indexed Single Life Annuity Sales (April 2012 = 100)



Source: IRESS At Retirement report, edition five, August 2015

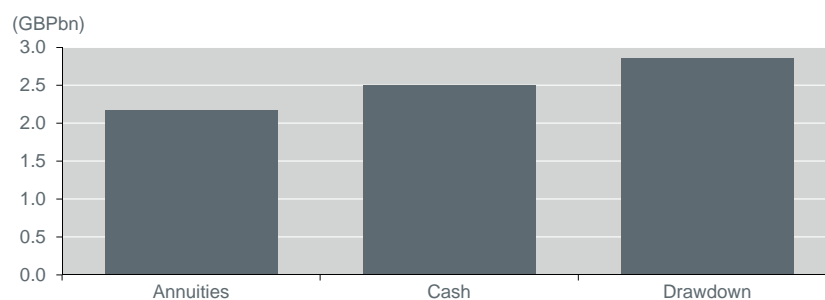
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Pensions Access – Latest Figures Show 3-Way Split

Use of Pension Pots, April-September 2015



Source: Association of British Insurers

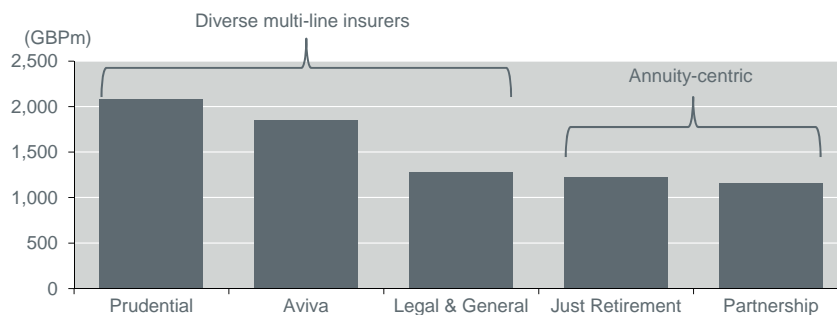
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Business Mix Determines Exposure to Annuity Decline

UK Individual Annuity Sales (2013)



Source: Companies

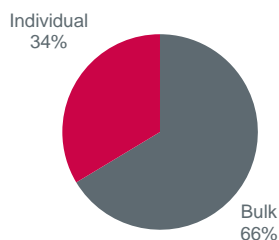
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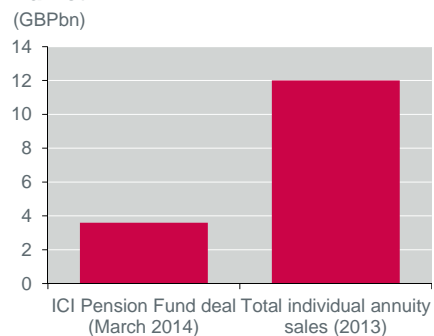
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Bulk Annuities Can Fill The Gap

Legal & General Annuity Assets
(End-1H15: GBP43.4bn)



Single Bulk Deal vs Total Individual Market
(GBPbn)



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Exposure to Low Bond Yields – UK Relatively Immune

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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UK Life 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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Negative Fundamentals Unlikely to Move Ratings

UK life ratings mostly stable, underpinned by:

- Diverse businesses
- Strong capital

Company	IFS Rating ^a	Outlook/watch
Prudential	AA	Stable
Legal & General	AA-	Stable
Scottish Equitable	AA-	Stable
Scottish Widows	AA-	Stable
Aviva	A+	Positive
Phoenix	A	Stable
Old Mutual	A-	Stable

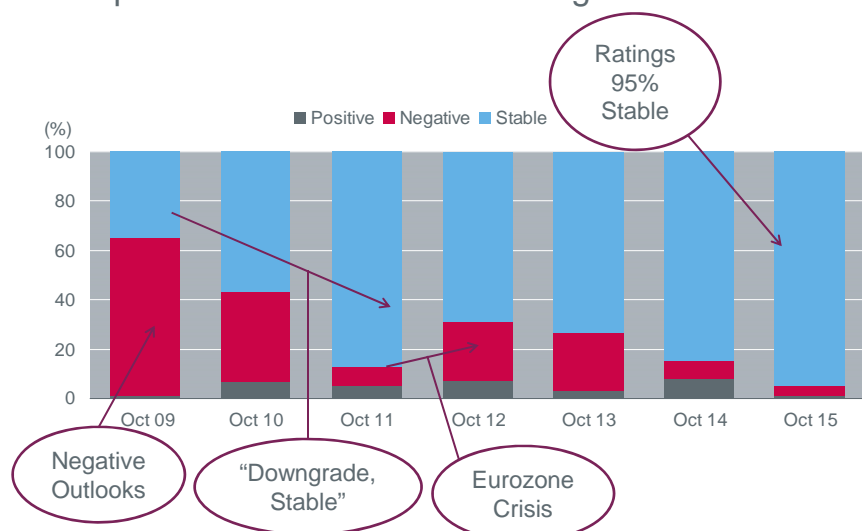
^a Insurer Financial Strength rating of core rated operating companies
Ratings as at 20 November 2015
Source: Fitch

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European Picture – Insurers' Rating Outlooks Stabilise



Source: Fitch

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Predictions for the Market – 2016 and Beyond

Products

- Shift from annuities to simple drawdown
- Pensions auto-enrolment growth
- Tax treatment drives pension savings

Distribution

- Advice shifting to restricted, robo or none
- Digital

Market Trends

- M&A
- Pension risk transfer to insurers
- Cost cutting



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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:

- Capital position excluding transitional benefits

Capital / M&A strategy

- “Delighted to have sold our acquisition”

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Some Things We've Heard

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

"QE is the biggest transfer of wealth not sanctioned by parliament, in the history of the western world"

"The biggest risk for insurers? Regulation by people who don't understand insurance"

"Government bonds = return-free risk"

"Some supervisors expect companies to conform with a number 100% higher than the SCR, which is ridiculous"

"Nowhere does it say you need to be 100% or even 20% above the SCR. Where is it going to stop?"

"The reality is we are a GSII. Do we do any systemic activities? No we don't. Which is interesting"

"The capital requirements are crazy – they kill products with high social value"


"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 28 January 2016, 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

- Insurance Rating Methodology – September 2015
- UK Budget Proposals Negative for Annuity Providers – March 2014
- Bulk Annuities To Help Insurers Handle UK Pension Change – March 2014
- 2015 Outlook: UK Life Insurance – December 2014
- Annuity Market in Flux – February 2015
- Significant Variation Likely in GSII Capital Requirements – July 2015
- UK Life Insurers On Track for Strong Solvency II Capital – August 2015
- Solvency II Infrastructure Class Will Attract Insurers – September 2015
- UK Life Insurance Dashboard – September 2015
- GSII List Puts Insurers' Business Strategy in Spotlight – November 2015

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Questions

Comments

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