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SECTOR IN-DEPTH
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Life Insurance - UK

A no-deal Brexit would weigh on UK life insurers' capitalisation and revenues

Our current base case is that the United Kingdom (UK; Aa2 stable) and the European Union (EU; Aaa stable) will reach an agreement governing the UK's withdrawal from the EU. However, the possible exit of the UK without an agreement and related transition period that preserves many of the current trading arrangements – a "no-deal" Brexit – would pose challenges for UK life insurers.

No-deal scenario would raise the risk of capital, growth and profit deterioration. The UK life sector, which has high asset leverage, faces two key risks related to a "no-deal" scenario. Firstly, financial market volatility may erode capital and pressure investment income. Significant market volatility pushes up capital requirements and also reduces asset values, a double negative for life insurers' Solvency II capital position. Secondly, a material negative impact on the UK economy may reduce revenue and earnings potential. A combination of weaker economic growth and business and consumer uncertainty is likely to weigh on life insurers' revenues and operating profits in the short to medium term.

Operational impact is manageable. We anticipate that operational risk will be manageable for the insurance sector in the event of a no-deal Brexit, as most UK life groups that operate in continental Europe do so via local subsidiaries. These will be able to continue operating even though their UK parents would lose their EU passporting rights.

Operating performance will still benefit from favourable structural shifts. In 2018, most UK life insurers again increased their operating profit. We expect the sector to continue to benefit from rule changes giving savers more freedom to manage their retirement savings, as well as structural shifts such as pensions auto-enrolment, and the move from defined benefits to defined contribution schemes.

No-deal scenario would raise the risk of capital, growth and profit deterioration

Within the insurance sector, we see UK life players as especially exposed to a no deal scenario. Our view reflects (i) their high asset leverage; (ii) their significant exposure to UK investments, given their policy of matching sterling-denominated liabilities with sterling-denominated assets; and (iii) the discretionary nature of some life insurance products, whose sales are correlated to the economic cycle.

The UK life sector therefore faces two key risks related to a no-deal scenario: (1) financial market volatility may weaken capital positions and pressure investment income; (2) a material, negative impact on the UK economy may reduce revenue and earnings potential.

Weaker capitalisation

We expect a no-deal Brexit to result in significant market volatility. This would weigh negatively on the industry's Solvency II capital position because asset values would fall, and because the increase in volatility would in itself prompt an increase in capital requirements.

UK life insurers' Solvency II ratios at YE18 remained comfortably above the 100% threshold at which increased regulatory scrutiny is triggered (see Exhibit 1). This gives them a robust cushion to absorb market volatility, provided it is relatively short-lived.

However, a significant and long-lasting fall in the value of an insurer's asset portfolio, particularly in the absence of any mitigating management action, would exert meaningful pressure on its solvency ratios. We see a widening of corporate credit spreads and corporate rating downgrades as a key sensitivity for UK life insurers, given that corporate bonds are used to back UK annuity liabilities. While the sensitivities shown in Exhibit 1 would not materially reduce some insurers' Solvency II ratios, they are shown on a stand-alone basis. In a no deal scenario, we would expect a number of these sensitivities to combine, magnifying the negative impact on solvency.

Exhibit 1
Sensitivities of UK life insurers' Solvency II ratio to market movements

		Ratio after			
Group	Solvency II ratio YE2018	fall in interest rates	rise in interest rates	credit spread widening	decline in equities
Aviva Plc	204%[1]	194% (-50 bps)	207% (+25 bps)	196% (+100 bps)[2]	199% (-25 %)
Legal & General	188%[1]	176% (-50 bps)	212% (+100 bps)	198% (+100 bps)[3]	182% (-25 %)
M&G Prudential	172%[1][7]	N/A	N/A	N/A	N/A
Royal London	202% (YE18)[1][4] 228% (YE17)	+£3mn in Solvency surplus (-100bps)	-£602mn in Solvency surplus (+100bps)	+£150mn in Solvency surplus (+100bps)	+£30mn in Solvency surplus (-25%)
Scottish Widows	156% (YE18)[4][5][6] 145% (YE17)	-£233mn in working capital (-100bps)	+£90mn in working capital (+100bps)	-£475mn in working capital (+100bps)	-£418mn in working capital (-25%)
Rothesay	157% (HY18)[4] 169% (YE17)	153% (-100 bps)	205% (+100 bps)	160% (+100 bps)[8]	N/A

decline between 5-15%pts | decline by more than 15%pts

[1] Solvency II ratio based on Shareholders'/Investor view [2] Corporate spreads [3] Assumes an escalating addition to ratings and excludes restructured LTMs [4] Sensitivities shown as of year-end 2017 [5] Sensitivities include TMTP recalculation [6] YE17 ratio post dividend [7] With-profits Solvency II ratio of 231% [8] Applicable to all non-government guaranteed assets
Source: Company reports

Longer economic uncertainty has reduced the likelihood of any interest rate increase in the short-term, and the 10 year UK government bond yield has already fallen from around 1.7% in early October 2018 to its current level of around 1%. UK life insurers can increase the transitional relief they receive on their technical provisions when the 10-year risk-free rate falls by at least 50bps. However, Exhibit 1 highlights that even with reset transitionals, interest rate falls can meaningfully reduce Solvency II ratios.

If a no-deal Brexit results in a further fall in risk free rates, the risk margin for UK annuity writers under Solvency II will increase, leading to a decline in capital ratios. At the same time, UK life insurers' interest rate risk would increase due to the presence of guarantees on their with-profits products.

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In addition to the impact on insurers' capital ratios, prolonged market volatility could also increase borrowing costs for UK insurers, and dampen customers' investment appetite.

Weaker economic growth to reduce insurance demand

The UK economy trades intensively with the rest of the EU, and a no-deal outcome would have significantly negative consequences. While there is a range of views regarding the magnitude of the economic impact, the International Monetary Fund (IMF) estimates that UK GDP could be 4% lower over the long term under a no-deal Brexit than under a negotiated exit. While life insurance sales volumes are not driven purely by economic growth, the combination of weaker growth and business and consumer uncertainty is likely to weigh on life insurers' revenues and operating profits in the short to medium term.

For example, a squeeze on real wages and higher unemployment would likely trigger a slowdown in non-compulsory pensions and savings business. A reduction in housing market activity could also weigh on UK life insurers' sales growth, as a high proportion of protection sales are linked to mortgage transactions.

At the same time in a no deal Brexit scenario, we expect property values to fall which, together with falling yields, will weigh on insurers' investment income. Although insurers' direct real estate holdings are typically relatively limited and well diversified, their total exposure is inflated by assets such as equity release mortgages and commercial property loans. Their property exposure has also grown in recent years in response to the low interest rate environment.

The profitability of life insurers' asset management operations could also suffer if volatile financial markets put funds under management and net client cash flows under pressure. However, one significant advantage that the UK life industry has over a number of European peers is that the majority of its reserves are unit-linked with no interest guarantees. The profitability of UK life insurers is therefore much less vulnerable to interest rates staying low for the next five years than that of their German, Dutch and Norwegian counterparts.

Operational impact is manageable

We anticipate that operational risk will be manageable for the UK life insurance sector, as most groups that operate in continental Europe do so via local subsidiaries. These will be able to continue operating after a no-deal Brexit, even though their UK parents would lose their EU passporting rights [1].

UK life insurers' EU subsidiaries, in addition to writing new EU business, could serve previous policies written in the UK for EEA policyholders (if any) via the transfer of these portfolios, thereby reducing the uncertainty of servicing these policies.

Regulatory risk for UK life insurers would be limited over the short to medium term if, as we expect, the UK's initial post-Brexit insurance regime attains Solvency II equivalence. We view this as a likely outcome, given the UK's close involvement in the development of Solvency II. Nevertheless, over the longer term, Brexit increases the risk of regulatory divergence between the UK and its former EU partners. This could reduce capital fungibility and increase regulatory costs for insurers operating in both jurisdictions.

Operating performance will still benefit from favourable structural shifts

In 2017 and 2018, most UK life insurers increased their operating profit, helped in part by favourable structural shifts. These include rule changes giving savers more freedom to manage their retirement savings, the automatic enrolment of employees into corporate pension schemes, and the move from defined benefit to defined contribution pension plans. We expect life insurers, some of which are expanding their asset management divisions, to continue to benefit from these changes, which give them significant asset gathering and fee generation capability.

A number of UK life insurers remain focused on risk products such as bulk annuities, a market that grew by c.65% to £20 billion of business volume in 2018. The increase reflects increased efforts by corporate and other pension funds to de-risk their defined benefit liabilities, which amount to a total of about £2 trillion in the UK. The bulk annuity market also has relatively high barriers to entry, and bulk annuities typically command much higher margins than savings products. However, a no-deal Brexit leading to a decline in bond yields could dampen demand for the product. This is because lower yields widen pension schemes' funding gaps, making bulk annuity deals less affordable.

The bulk annuity market has also become more competitive recently, and competition could further increase depending on the extent to which "superfunds"[2] are able to acquire business more cheaply than the existing traditional players. Furthermore, bulk annuity writers rely on reinsurers to off-load longevity risk, and the ability to source higher-yielding illiquid assets is critical to profitability.

Moody's related publications

- UK Life Outlook: Expectation of continued resilient performance drives stable outlook, 13 September 2018
- Cross-Sector – United Kingdom: Probability of a 'no-deal' Brexit has risen, and would be negative for an array of issuers, 13 September 2018

Endnotes

1 EU legislation currently in force gives (re)insurers in a Member State the ability to carry on business and sell services throughout Europe without obtaining a licence in each individual country - this concept is known as "passporting"

2 On 7 December 2018, the UK government launched a consultation seeking views on a new legislative framework for authorising and regulating defined benefit "superfund" consolidation schemes.

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