STANDARD & POOR'S RATINGS SERVICES

RatingsDirect®

U.K. Life Insurers Face Hard Choices As Low Interest Rates Coincide With Widespread Regulatory Reform

Primary Credit Analyst:
Oliver Herbert, London (44) 20-7176-7054; Oliver_Herbert@standardandpoors.com

Secondary Contacts:
Simon Ashworth, London (44) 20-7176-7243; Simon_Ashworth@standardandpoors.com
Sanjay Joshi, London (44) 20-7176-7087; Sanjay_Joshi@standardandpoors.com
Mark Button, London (44) 20-7176-7045; mark_button@standardandpoors.com

Table Of Contents

1040488 | 301967406

U.K. Life Insurers Face Hard Choices As Low Interest Rates Coincide With Widespread Regulatory Reform

The ongoing regulatory changes in the U.K. life insurance market have required a strategic response from all players, even the market leaders. At the same time, continued macroeconomic uncertainty serves to constrain the margin for error.

In order of implementation, the immediate regulatory changes insurers must adjust to include:

- Auto-enrolment, which ensures that employees are automatically enrolled into a company pension scheme, started to come into effect from October 2012 for the largest employers.
- Gender-neutral pricing will prevent insurers from underwriting on the basis of gender. It will be implemented on Dec. 21, 2012.
- The U.K. Financial Services Authority's Retail Distribution Review (RDR), which will change how products are sold, preventing insurers from paying commission to intermediaries on retail investment products. It will be implemented on Dec. 31, 2012.
- The change in regulatory authorities as the Prudential Regulation Authority and the Financial Conduct Authority assume their powers in early 2013.

In Standard & Poor's Ratings Services' view, the insurers in the U.K. life sector that we expect to maintain or enhance their credit strength after the regulatory changes will be those that can build on their competitive advantages across a broad number of product lines and distribution channels. Across the industry, capitalization remains robust and has benefitted from significant reductions in risk. Furthermore, we consider the balance sheets of the U.K. life sector to be liquid. Most liabilities to which shareholders are exposed are long-dated, and illiquid. These liabilities are, in general, matched with highly liquid and highly rated bonds.

Credit Factors For The U.K. Life Industry As A Whole

Positive credit factors

- Robust capitalization of the sector.
- Significantly reduced risk in its asset portfolios.
- Long-dated liabilities pose low liquidity risk.

Negative credit factors

- Regulatory change may place a strain on some business models.
- Low interest rates weigh on operating performance and solvency.
- Macroeconomic pressure on savings flows.

Future earnings in the U.K. life insurance sector are sensitive to the state of the U.K. economy. We anticipate continued macroeconomic pressure is likely to constrain growth. Furthermore, insurers offering savings products face ongoing competition from the banking and asset management sectors. While the life insurance industry has taken steps to mitigate the impact of low interest rates, we expect this to continue to depress operating earnings and challenge our view of capital strength. We believe the industry risks have led some groups to sell their operations in the U.K. or in certain cases have resulted in Standard & Poor's weakening its assessment of group support where insurers in the U.K. have foreign parents.

As The Market Adjusts To Regulatory Change, New Life Sales Are Likely To Dip Over 2013 And 2014

Historically, most U.K.-based independent financial advisors (IFAs) have used a commission-based business model for financial advice. The IFA market was responsible for 78% of annual premium equivalent (APE) sales in 2011. Most of the life insurers based in the U.K. that are rated by Standard & Poor's have little overseas diversification. These companies are therefore likely to see their future volumes subject to uncertainty from Dec. 31, 2012, when the RDR comes into effect.

Under the RDR, insurers will no longer be able to use commission paid to advisers of investment products as a differentiator to win business. Consumers will need to pay for investment advice. As a result, product features, service standards, the ability to access the market, and the strength of brands will become the key selling points. Some insurers have already stopped competing on commission, but others are still redefining their competitive strengths now that commission can no longer be used.

Some strategies adopted are only short-term solutions

Many insurers saw bank branches as a means of capturing consumer savings flows and so maintain volumes in an RDR world. However, one high street bank after another has announced its withdrawal from the sale of savings and investment products to the mass market during 2012; bancassurance distribution is not the answer. We consider that banks are indicating their belief that they cannot provide investment advice to certain consumers at a price they are willing to pay.

Some insurers have even adopted the strategy of increasing the sale of commission-based corporate pension products, with a view to securing business now and providing opportunities as auto-enrolment comes into effect. Others have adopted longer-term solutions and have invested significantly in front-facing and back-office software to improve the customer experience. Still others have taken steps to change their product mix to focus on protection, which is exempt from RDR.

Other sources of uncertainty will also affect short-term sales

Although we consider the RDR to be a key change affecting sales of savings, investments, and pension products, in our view, it is only one of the regulatory changes affecting insurers in the U.K. (see table 1). These changes are occurring at a time when the regulatory authorities are themselves undergoing transformation, which risks generating further uncertainty among market participants.

Impact Of Upcoming Regulatory Changes On Insurance Providers And Consumers

Date	Name	Change	Impact
Main regulatory changes			
From October 2012 to 2018	Auto-enrolment	Automatic enrolment of employees into company pension schemes	Expand size of corporate pensions market. Insurers with established competitive advantages will be best placed to benefit. Reaction of consumers and effect on competitive environment remain unclear.
Dec. 31, 2012	Retail Distribution Review	Changes to the distribution practices and processes for retail investment products	Short-term uncertainties as to how stakeholders adapt. Longer-term improvements in quality of sales and length of time that consumers keep their product with an insurer.
Jan. 1, 2014 (official target date for full implementation, but extension to 2016 appears likely)	Solvency II	New EU-wide regulatory framework	Most uncertain forthcoming regulatory change. Regulatory capital requirements and risk management practices will change.
Other regulatory changes			
Came into force March 2012; full implementation by March 1, 2013	Annuity code of conduct	ABI rules surrounding increased competition at annuity vesting	Consumers encouraged to "shop around" at retirement for best annuity deal.
From April 1, 2012	PS12/4	FSA's policy statement on changes to with-profits regulation	Various changes, including the fair treatment of with-profits policyholders, the distribution of surplus, and the effect of material reductions in new business.
Dec. 21, 2012	Gender-neutral pricing	Product pricing should not consider gender	Products such as protection and annuities will be affected. We anticipate price rises for women in protection and for men in annuities.
To be confirmed, but expected to be April 1, 2013	Prudential Regulation Authority/Financial Conduct Authority	New regulators for insurance sector	New regulatory framework separating prudential supervision and conduct of business into two new regulatory bodies. Shift toward an enhanced ICA regulatory regime incorporating aspects of Solvency II.
Jan. 1, 2013	Protection tax changes	Change in the taxation methodology for protection products	Some insurers will lose the pricing advantage on protection products they currently gain through their tax position.
To be confirmed	Global Systemically Important Insurers	To reduce the moral hazard behaviour and disoderly failure of systemically important insurers	Some insurers will be subject to increased supervision and capital requirements.
To be confirmed	Revised Insurance Mediation Directive	Changes to the minimum level of consumer protection for sales of insurance products	EU-wide change in legislation aimed at improving remuneration transparency and removing conflicts of interest. Unclear how measures will interact with Retail Distribution Review.
To be confirmed	CRD IV	EU-wide implementation of Basel III.	May lead to changes in the nature of bank investment in insurance companies.
To be confirmed	Consumer Insurance Bill	Change to insurance policy underwriting process	Emphasis shifts so that insurers must ask relevant questions at underwriting stage, as opposed to consumers needing to disclose all relevant information.
To be confirmed	Solvency II tax changes	U.K. life insurance taxation system	Basis for U.K. taxation will change following the introduction of Solvency II.

ABI--Association of British Insurers. FSA--Financial Services Authority. ICA--Individual Capital Assessment. CRD--Capital Requirements Directive.

Volumes are also constrained by the macroeconomic environment in which this regulatory change is taking place. In the lead up to the RDR, APE sales growth has come from pension sales; there has been limited absolute growth in other lines of business. We also anticipate that the banking and asset management sectors will continue to compete for savings flows over the rating horizon (see economic projections published in "The Eurozone's New Recession--Confirmed," published on Sept. 25, 2012). The combination of these factors will constrain the U.K. life insurance sector's room for strategic maneuver and potential margin for error. In particular, capital market uncertainty and depressed savings volumes could mean investment in distribution infrastructure may take longer to recoup than expected.

We anticipate a dip in new life sales is likely over 2013 and 2014 as the market readjusts after the introduction of the RDR. Key areas of uncertainty include how pricing will change as a result of the removal of commission and whether consumers will make the shift to paying upfront for advice. We expect sales of corporate pensions to be hit especially hard as smaller schemes will now be required to pay fees for advice under the RDR.

An employee opt-out system for corporate pensions (auto-enrolment) could help to mitigate the potential downside risks from the RDR. Market participants appear to be expecting auto-enrolment to spark a significant uplift in volumes. However, we consider that pressure on household incomes may make capturing this business difficult. More employees than expected may choose to opt out or employers may choose to use the National Employment Savings Trust (NEST) scheme instead. Insurers may also struggle to retain their current schemes; we expect some employers to see auto-enrolment as an opportunity to review the whole of their pension and risk benefits offering.

Gender-neutral pricing will prohibit insurers from underwriting on the basis of gender. Some insurers may underwrite using characteristics for which gender has merely been a proxy. However, in general, we expect prices to increase to hedge the gender risk: women will pay more for protection and men will pay more for annuities.

Expected shifts in product mix will reflect the legislation

In terms of product mix, we expect that post-RDR, the sale of protection products will account for a greater share of APE as the IFA community seeks to maintain income from sales. Over the medium term, gender-neutral pricing and tax changes to protection may lead to increases in prices; in our view, insurers are unlikely to accept a fall in margins given the low interest rates. However, over the medium term, increased competition in this segment may force prices down.

Low Interest Rates May Depress The Quality Of Investments And Capital Strength As Insurers Look To Maintain Earnings

Turning from the U.K. life insurance sector's future earnings potential to the management of the back book of business, we consider that the sector continues to exhibit robust capitalization. We expect this to remain a source of strength to our ratings over the rating horizon, although low rates are affecting capitalization and operating performance.

Low interest rates are testing capitalization and earnings

Low interest rates continue to affect capitalization, as demonstrated by the deterioration in with-profit fund risk capital margin (RCM) solvency from 4.3x in 2010 to 3.2x in 2011. This decrease in solvency occurs at a time when we continue to see equity holdings in with-profit funds falling; we would normally expect this to cause the solvency requirements in the RCM to fall. In general, the low level of guarantees provided within the U.K. life sector reduces the risk to capital from low interest rates. Where insurers have offered interest rate guarantees on certain products, these are often hedged. However, despite these mitigating features, we consider a prolonged period of low rates to be a key challenge for the sector.

Low interest rates chiefly weaken operating performance in two ways--low rates reduce both new business margins and earnings from the back book. Insurers have sought to manage the pressure on new business margins by significant and frequent re-pricing. The effect on the back book stems from where insurers have duration mismatched their assets and liabilities and need to reinvest at yields much lower than anticipated when the product was initially sold. To some degree, this is mitigated by the sector's strong asset-liability management; the ability to lower with-profit bonuses; and the growing proportion of liabilities with no guarantees which are fee-based, rather than spread-based.

Life insurance liquidity presents a valuable asset

In our view, certain segments of the U.K. life sector carry illiquid liabilities, but have liquid asset portfolios. For example, annuities cannot be surrendered and with-profit funds can guard against the impact of withdrawals by levying surrender charges. This liquidity mismatch has a market value and the current economic and competitive climate may encourage insurers to extract that value.

A number of insurers have taken advantage of their liquidity mismatch by choosing to enter into securities lending programs and asset swaps to realize the value of the liquidity on their balance sheets. However, asset swap structures require significant risk management capabilities, in our opinion. Risks include those associated with: the quality and liquidity of collateral held; how the securities on loan are used; and the speed at which the structures can be unwound. The counterparties for these structures are often banks, which increases the systemic importance of those life insurers that perform these transactions and could lead to greater regulatory scrutiny, and even additional capital requirements.

Interest rates may place a strain on investment allocations and trigger a return to cost-cutting

We have seen little indication that large-scale changes in asset allocation are occurring across the sector. However, we expect that greater weight may be given to commercial mortgages and infrastructure in anticipation of Solvency II and in the search for yield. Though we have seen a small shift away from 'AAA' and 'AA' rated bonds toward 'BBB' rated bonds, in our view the degradation in the credit quality of the sector's bond portfolio is not yet material. However, low interest rates may also increase pressure on insurers to look further down the credit quality curve, with a view to enhancing investment returns.

Finally, after the financial turmoil of 2008 and 2009, several insurers in the U.K. life sector responded to reduced volumes and market volatility by announcing expense reductions. These publically announced programs are now largely complete. Given the continued pressure on volumes and earnings, we expect many players to focus on cost-containment once again, as a means of maintaining earnings and price competitiveness.

The combination of low interest rates and regulatory change offers the U.K. life sector a heady mix of threats and opportunities. We anticipate that in 2013 we will start to gain clarity on a number of areas which are presently uncertain. Specifically, we expect to know how consumers will respond to having to pay for investment advice, and how IFAs will change in response to having to charge their clients. It should also become clear how much upside auto-enrolment will really offer and how many employees will choose to opt out. As a result, it should be more apparent which strategies have enabled insurers to maintain earnings.

As the present and upcoming challenges resolve themselves, we expect those insurers that enter 2013 with a broad distribution base that is not reliant on commission to do best. In addition, those that have access to the market via a number of routes or whose customers have already made the cultural transition to paying for their advice will likely gain most from the changes under RDR. The insurers that can extract value from auto-enrolment will be those that are able to retain and select schemes without weakening their profitability and those that can exploit the opportunity to sell a broader suite of benefits. In our opinion, an insurer will need to execute this strategy efficiently, without weakening the balance sheet, if it is to maintain or enhance its credit strength.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal.

- The Eurozone's New Recession--Confirmed, Sept. 25, 2012

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com