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Scottish Equitable PLC

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Scottish Equitable PLC

SACP* Assessments				SACP*		Support		Ratings
Anchor	bbb+	Modifiers	0	bbb+		3		Financial Strength Rating
Business Risk: Satisfactory		ERM and Management	0	Liquidity	0	Group Support	3	A+/Negative/--
Financial Risk: Moderately Strong		Holistic Analysis	0	Sovereign Risk	0	Gov't Support	0	

*Stand-alone credit profile.
See Ratings Detail for a complete list of rated entities and ratings covered by this report.

Rationale

Business Risk Profile: Satisfactory

- Significant risks remain for U.K. life insurer Scottish Equitable PLC (SEPLC) regarding the execution of its strategy to build its fee-based business.
- SEPLC benefits from the U.K. life insurance sector's low industry and country risk, supported by its strong institutional framework and strong track record in asset-liability management.
- In our view, SEPLC's longstanding history in the U.K. market and well-established relationships with intermediaries supports its good competitive position. However, earnings remain a weakness relative to peers.

Financial Risk Profile: Moderately Strong

- We assess SEPLC as having strong capital and earnings, supported by its capital-light strategy--seen, for example, in the sale of its U.K. annuity business.
- A sizable pension scheme exposure also weighs on our risk position assessment.

Other Factors

- We consider SEPLC to be strategically important to the Aegon group, and therefore our rating on SEPLC benefits from three notches of uplift for group support.

Outlook: Negative

The negative outlook on SEPLC is based on the outlook on core entities of the Aegon group. Furthermore, it reflects the continued risks and uncertainties in SEPLC's ability to execute its strategy and deliver results that support its strategic importance to the group.

Downside scenario

A downgrade of the Aegon group is likely to lead to a similar rating action on SEPLC. Furthermore, we could lower the ratings if we revise our view of SEPLC's group status to moderately strategic.

This could occur if:

- New business margins are unlikely to be positive at year-end 2017;
- The U.K. operations fail to integrate the Cofunds business successfully; or
- Although unlikely, capital adequacy declines to levels significantly below the 'A' level of confidence, according to our capital model.

Upside scenario

Our revision of the outlook on SEPLC to stable is primarily dependent on a similar action on the Aegon group, together with successful execution of SEPLC's strategy.

Base-Case Scenario

Macroeconomic Assumptions

- We expect U.K. real GDP growth of 1.4% at the end of 2017 before reducing to 0.9% in 2018.
- We expect the U.K. 10-year government bond yield to drop and remain around 2.0% over the next year.

Company-Specific Assumptions

- Modest profits in second-half 2017.
- Return on capital near 5% over 2017-2018.
- At least strong capital and earnings.

Key Metrics

	--Year ended Dec. 31--		
	2018F	**2017F**	**2016**
Net income (mil. £)	80-100	80-100	(2.0)
Return on shareholders' equity (%)	5.0	5.0	(0.1)

F--Forecast.

Company Description

SEPLC is the main operating company of Aegon UK. Aegon UK also includes independent financial advisor (IFA) network Origen. Following the acquisitions of BlackRock's U.K. defined contribution platform and administration business and Cofunds platform business, the total assets on the platform increased to £107 billion at half year-2017. This is in line with the group's strategy to focus on growing its platform business. At the same time, it sold most of its annuity book.

SEPLC mostly sells unit-linked pensions business, together with some protection. Technical provisions comprise mostly unit-linked reserves.

Business Risk Profile: Satisfactory

Insurance industry and country risk: Low, supported by strong institutional framework and low asset-liability mismatch

SEPLC is exposed to the U.K. life insurance market, which we assess as being low risk. This reflects our view of the U.K.'s low country risk and intermediate industry risk, and is supported by our positive opinion of the institutional framework and the sector's strong track record of minimizing asset-liability mismatches. We consider that the sector is highly competitive, but that it nevertheless maintains moderate levels of profitability (for more information see "U.K. Life Insurance Industry And Country Risk Overall Remains Low, Despite Brexit Outcome," published on July, 12, 2016).

Table 1

Scottish Equitable PLC Industry And Country Risk

Insurance sector	IICRA*	Business mix (%)
U.K. life	Low Risk	100

*Insurance industry and country risk assesment.

Competitive position: Increased risks and uncertainties in transforming into a capital-light, fee-based business in a highly competitive market

SEPLC is a well-established player. It has a long history, is well-known among the intermediary community, and is one of the largest players in the platform business.

SEPLC's strategic focus is on developing and marketing its platform offering to sustain its market position. In our view, these developments, if successfully implemented, would support SEPLC's competitive position and enable the company to generate better returns. However, we think that the execution of this strategy in a highly competitive market comes with significant risks and uncertainties. Currently, there are more than 30 other platform providers.

In addition, SEPLC's business is focused on the highly competitive pensions business. This concentrated business model also weakens our view of its competitive position.

SEPLC's margins on its new business were negative historically, mostly due to lack of scale of its platform business. However, as a result of recent acquisitions and the continuing transfer of its unit linked to its platform business, SEPLC achieved a positive margin at H1 2017. Hence the company is in a good position to improve its earnings.

In terms of brand and profitability, we still consider that SEPLC lags behind higher-rated peers, particularly post the sale of its annuity business.

We consider that uncertainties remain around the development of persistency rates as SEPLC completes the transfer of assets onto its platform and as the auto-enrolled-schemes market develops.

Finally, although SEPLC has launched a new direct-to-consumer proposition, we expect that distribution will remain biased toward IFAs over at least the next two years. We do not consider that providers have much control over the IFA channel.

Table 2

Scottish Equitable PLC Competitive Position

	--Year ended Dec. 31--				
(Mil. £)	**2016**	**2015***	**2014**	**2013**	**2012**
Gross premium written	7,997	5,996	3,917	5,547	4,900
Change in gross premium written (%)	33.4	53.1	(29.4)	13.2	(11.2)
Net premium written	(1,867)	5,652	3,573	5,206	4,563
Change in net premium written (%)	(133.0)	58.2	(31.4)	14.1	(12.7)
Total assets under management	54,528	58,512	59,830	57,267	55,372
Growth in assets under management (%)	(6.8)	(2.2)	4.5	3.4	6.2
Reinsurance utilization (%)	123.3	5.7	8.8	6.1	6.9

*Amounts have been restated for a voluntary change in accounting policy.

Financial Risk Profile: Moderately Strong

Capital and earnings: Likely to remain strong

We anticipate that SEPLC will maintain its strong capital and earnings, particularly following the sale of its annuity business. The latter has reduced the asset and liability capital requirements significantly. Our view of the company's risk-based capital takes into account the reliance on weaker capital components (the value in force implied on Solvency II basis) and the uncertainty around the level of capital return to its parent. That said, we recognize the company is committed to maintaining solid coverage under the Solvency II capital regime. We anticipate nearly 165% coverage at the end of 2017, including the impact of the annuity sale and a dividend payment to the parent. We do not expect aggressive levels of capital return to SEPLC's parent.

We expect earnings to be slightly affected by the ongoing costs of platform-related expenses and asset de-risking; however, we anticipate they will improve progressively over the rating horizon as the platform expands and margins improve.

Over 2017-2018, we expect SEPLC's earnings to be between £80 million and £100 million annually.

At the wider Aegon group level, we expect earnings to improve over the medium term, as the group increases the scale of its platform business by: (i) transferring its old unit-linked business onto the platform, as well as integrating the recently acquired Cofunds business; and (ii) attracting new U.K. pensions and savings business.

Table 3

Scottish Equitable PLC Capitalization					
	--Year ended Dec. 31--				
(Mil. £)	**2016**	**2015***	**2014**	**2013**	**2012**
Shareholder equity	1,721	1,682	2,288	2,993	4,014
Change in shareholder equity (%)	2.3	(26.5)	(23.5)	(25.4)	17.0
Shareholders' funds excluding revaluation reserves	1,673	1,675	2,264	2,440	3,162

*Amounts have been restated for a voluntary change in accounting policy.

Table 4

Scottish Equitable PLC Earnings Statistics					
	--Year ended Dec. 31--				
(Mil. £)	**2016**	**2015***	**2014**	**2013**	**2012**
Total revenues	9,408	7,699	5,626	7,332	6,478
Net income	(2)	(589)	176	108	171
Return on shareholders' equity (reported) (%)	(0.1)	(29.7)	6.6	3.1	4.6
Life: Prebonus pretax earnings/total assets (%)	0.1	(0.9)	0.5	0.3	0.5

*Amounts have been restated for a voluntary change in accounting policy.

Risk position: Moderate, reflecting risks and uncertainties related to the transformation of the business model

The execution of SEPLC's strategic transformation has the potential to add volatility to capital and earnings. SEPLC's material pension scheme exposure also weighs on its risk position as it could contribute to volatility. However, our view of its risk position is supported by material reductions in risk in the with-profits fund, reducing the company's exposure to interest rate and market risk. Furthermore, the annuity sale has de-risked SEPLC's balance sheet.

Table 5

Scottish Equitable PLC Risk Position					
	--Year ended Dec. 31--				
(Mil. £)	**2016**	**2015**	**2014**	**2013**	**2012**
Total invested assets	54,528	58,512	59,830	57,267	55,372
Net investment income	1,342	1,642	1,652	1,725	1,890
Net investment yield (%)	2.4	2.8	2.8	3.1	3.5

Financial flexibility: Dependent on the Aegon group

Following the sale of its annuity book, SEPLC's potential need for additional capital has reduced significantly. We expect the Aegon group to provide capital to SEPLC if it needs it. SEPLC's funding needs are largely dependent on the Aegon group, bearing in mind it is strategically important to the group.

On a stand-alone basis, financial flexibility is supported by the lack of debt on the balance sheet.

Other Assessments

Enterprise risk management: Strong controls in place

We view SEPLC as integrated into the Aegon group with regard to enterprise risk management (ERM). We assess the group, and therefore SEPLC, as having strong ERM, reflecting our positive view of the risk-management culture, risk controls, and strategic risk management of this complex organization.

We continue to view ERM of low importance to SEPLC, reflecting its capital-light, simple business model. This is supported by the sale of majority of its U.K. annuity book.

We view the risk management culture as positive. SEPLC operates a clear risk governance structure using a three-lines-of-defence framework. Its Supervisory Board is ultimately responsible for approving the U.K. division's risk strategy. Risk exposure monitoring and risk appetite, however, is more in line with the adaptations of the local regulatory framework. The capital triggers and bottom-up escalation requirements, as a function of the buffer above the regulatory requirement position, are clearly defined.

We assess risk controls as positive. Financial risks are actively managed using derivatives and several other management actions, particularly vis-à-vis the profits fund. ALM initiatives are regularly considered in order to control market risk exposures. Policyholder behaviour risk now ranks higher than longevity risk given reduced annuity volumes compared to previous years. Insurance risks in general are mitigated using reinsurance, and net risks retained are reviewed regularly and monitored against group-approved limits.

We view the risk model as neutral. The risk framework predominantly relies on the locally approved risk-based regulatory model, which is under a strong governance framework. The choice of the group's economic framework depends on the decision-making circumstance and suitability.

Management and Governance: Satisfactory, reflecting progress made so far in transforming the business, although risks exist around strategy execution and delivery

SEPLC's strategy is primarily focused on building its fee-based business. While we believe that the abovementioned acquisitions will contribute positively to the company's scale, we recognize the execution risk. That said, we think that SEPLC's strong risk controls mitigate this risk to some extent.

Recent signs that the platform is gaining traction give us some confidence in the platform strategy's chances of success. Furthermore, we consider that the team's success in cutting costs has materially improved SEPLC's earnings prospects.

There appears to be significant depth and breadth in the leadership team, with no evidence of key-man risk. The Aegon group has shown signs that it is willing to move people across the group, which we think helps avoid key-man risk.

We have a fairly positive view of SEPLC's financial management; we think SEPLC's risk appetite statements are detailed and comprehensive, and that it has a reasonably low appetite for financial risk. We have observed this in recent years; for example, partially hedging equity risk from the fees arising from unit-linked business; reducing risk in its with-profits fund; or more recently, de-risking its portfolio in line with Solvency II-related constraints, as evidenced by the sale of most of its U.K. annuity book.

Liquidity: Exceptional

We regard SEPLC's liquidity as exceptional, owing to the strength of available liquidity sources. We have no concerns regarding refinancing risk and we consider the group capable of managing unexpectedly large claims or an increase in life insurance policy lapses.

Support

Group support: Strategic importance to the Aegon group is under pressure as the business transforms

We view SEPLC as strategically important to the Aegon group. This reflects SEPLC's focus on products and markets that are important to the Aegon group's long-term strategy, the material size of its business within the group, and the capital injections in 2013.

However, we see significant pressure building on our assessment of the group status related to the risks and uncertainties around the ongoing strategic transformation. The U.K.'s cash generation and market-consistent value of new business margins have also continued to lag behind those of the rest of the group.

The Aegon group previously stated that its U.K. business had a target of 8% ROE by 2015. We consider that SEPLC will need time to reach this target. Factors contributing to this include the drag on returns from legacy business and expenses relating to restructuring and regulatory change.

SEPLC's stand-alone credit profile is 'bbb+'.

Accounting Considerations

The accounts for SEPLC are prepared under International Financial Reporting Standards.

Local regulations mean that the regulator does not recognize the free assets in the closed with-profits fund when calculating regulatory solvency. S&P Global Ratings' capital model recognizes that capital in the with-profits fund is available to meet the risks in the fund.

Related Criteria

- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Aegon Group, May 26, 2017
- U.K. Life Insurer Scottish Equitable 'A+' Rating Affirmed; Outlook Remains Negative, Feb. 10, 2017
- U.K. Life Insurance Industry And Country Risk Overall Remains Low, Despite Brexit Outcome, July 12, 2016

Ratings Detail (As Of November 23, 2017)	
Operating Company Covered By This Report	
Scottish Equitable PLC	
Financial Strength Rating	
Local Currency	A+/Negative/--
Counterparty Credit Rating	
Local Currency	A+/Negative/--
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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