MOODY'S INVESTORS SERVICE

CREDIT OPINION
15 January 2019

Update

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RATINGS

The Royal London Mutual Insurance Society Ltd

Domicile	United Kingdom
Long Term Rating	A2
Type	Insurance Financial Strength
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Royal London Mutual Insurance Society Ltd.

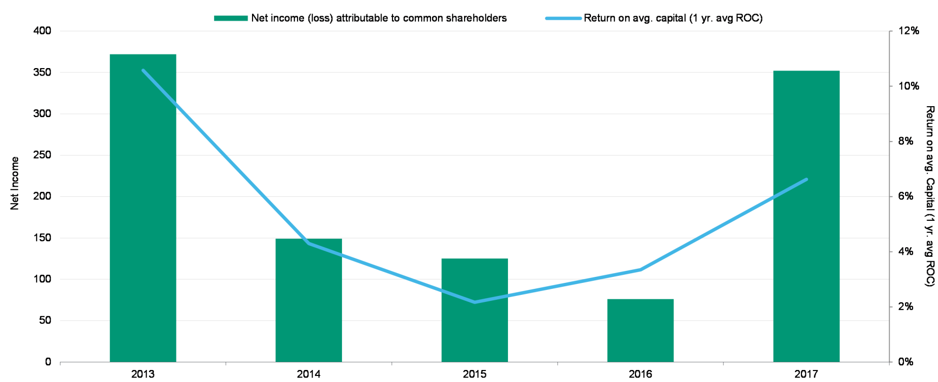
Semi-annual update

Summary

The A2 Insurance Financial Strength Rating ("IFSR") for The Royal London Mutual Insurance Company Ltd. ("Royal London" or "Group") and the Scottish Life Fund, a sub-fund of Royal London, reflects the high level of capital adequacy and the relatively low risk of its product mix. This is partly offset by a small market share relative to peers in the very competitive UK life market and an elevated exposure to high-risk assets. Nevertheless, Moody's notes that the investment risk is partially mitigated by considerable hedging protection and the participating nature of the liabilities, which enable sharing of investment risk with policyholders if financial markets decline.

Exhibit 1

Net Income and Return on Capital (1 yr. avg.)



"Net Income attributable to common shareholders" represents "Transfer to the unallocated divisible surplus from continuing operations, before other comprehensive income"
Source: Company reports and Moody's Investors Service

Credit strengths

» Strong capitalisation

» Low leverage metrics

» Relatively low risk profile with approx. 50% of IFRS technical liabilities being in unit-linked policies

Credit challenges

» Limited market share relative to UK peers

» Regulatory headwinds in the UK life industry as well as expectations of heightened competitive pressure

» Limited geographic diversification due to a focus on the UK life market

» Mutual status reduces financial flexibility relative to competitors, driven by the lack of access to equity markets and by the limited access to debt markets in potential stress scenarios

» High exposure to equities and property in the with-profit funds, although this risk is mitigated to an extent by the liability profile, hedging and the hypothecation investment strategy

Rating outlook

The outlook is stable, reflecting Moody's current expectation that the impact of Brexit on Royal London will be moderate over the next 12 to 18 months. We expect Royal London to maintain a strong capitalisation and its profitability and financial flexibility to remain broadly commensurate to the current financial strength rating. A continued commercial success of the "Royal London" brand and mutual identity in addition to auto-enrolment and rising contribution rates are likely to support new business sales over the next 2-3 years.

Factors that could lead to an upgrade

Positive rating pressure for Royal London could arise from a material increase in market share within the UK life and pensions market with no deterioration in its profitability and capital adequacy fundamentals.

Factors that could lead to a downgrade

Negative rating pressure could arise from 1) a substantial deterioration in the Group's economic capitalisation due to market disruption events or active M&A, or 2) a Sharpe ratio consistently below 100% and/or new business margin on Life & Pension business consistently below 1%, or 3) an adjusted financial leverage in excess of 30%.

Key indicators

Exhibit 2

The Royal London Mutual Insurance Society Ltd [1][2]	2017	2016	2015	2014	2013
As Reported (Pound Sterling Millions)					
Total Assets	99,319	90,631	74,656	73,934	64,301
Total Shareholders' Equity	-	-	-	-	-
Net income (loss) attributable to common shareholders	352	76	125	149	372
Total Revenue	7,045	11,489	2,977	7,320	4,728
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	549.8%	529.1%	369.2%	387.2%	397.7%
Goodwill & Intangibles % Shareholders' Equity	15.8%	20.1%	24.4%	28.2%	32.9%
Shareholders' Equity % Total Assets	1.8%	1.8%	2.9%	2.8%	3.0%
Return on avg. capital (1 yr. avg ROC)	6.6%	3.3%	2.2%	4.3%	10.6%
Sharpe Ratio of ROC (5 yr. avg)	162.7%	123.2%	119.7%	130.8%	147.6%
Financial Leverage	16.3%	18.4%	16.9%	13.5%	16.9%
Total Leverage	18.4%	20.8%	19.3%	17.7%	21.1%
Earnings Coverage (1 yr.)	8.9x	9.5x	3.1x	9.7x	15.4x

[1] Information based on IFRS financial statements as of Fiscal YE December 31
[2] Certain items may have been relabeled and/or reclassified for global consistency
[3] "Net Income attributable to common shareholders" represents "Transfer to the unallocated divisible surplus from continuing operations, before other comprehensive income"
Source: Company reports and Moody's Investors Service

Profile

Royal London is a UK-based life assurance group which writes a range of products, most notably unit-linked savings for retail and corporate customers as well as life protection business, predominantly through the Independent Financial Adviser channel ("IFA"). Royal London is the largest mutual insurance group in the UK.

As at 31 December 2017, it held £114 billion of funds under management via its asset management business, Royal London Asset Management. At the same date the issuer reported £99.3 billion of total assets and £3.7 billion of unallocated divisible surplus on its IFRS balance sheet.

Detailed credit considerations

Moody's rates Royal London A2 for Insurance Financial Strength, which is in line with the adjusted rating indicated by Moody's insurance financial strength rating scorecard.

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market Position and Brand: Modest market share drives the rating although sales volumes grow materially

Royal London is a smaller player than most peers in the competitive UK life insurance market with a slightly below-average new business market share estimated at approx. 5%. The company's market share has grown in recent years following good organic growth and a number of acquisitions (such as The Co-operative Insurance Society Limited (CIS)) mostly within the closed-fund with-profit segment, which contributed to acquiring larger scale to attract further new businesses, especially corporate clients.

Like a number of domestic UK life insurers, we believe Royal London may be affected by political and regulatory headwinds in the market as well as heightened competitive pressure from larger players, which may result in lower margins. Particularly, we believe Royal London may be vulnerable to political intervention in auto-enrolment schemes following the introduction of the 75bps charge cap and given the potential for further reductions. More positively, we believe Royal London can benefit from the pension flexibility reforms as its product proposition is more oriented towards income drawdown with very limited exposure to annuities, as demonstrated by sustained growth in sales volumes and new business value in recent years. Additionally, 2017 and H1 18 sales benefited from the strategic deal with the Post Office, whereby Royal London is the sole provider of Life and Pension products to the Post Office network of 11,000+ branches across UK.

PVNBP on life and pensions business grew by a strong 38% to £12,002 million in 2017 driven by continuing strong growth in pensions (up by 39%) and higher-margin protection business (up by 25%). We also note that the direct-to-consumer business, while smaller relative to other segments, grew strongly in 2017, with PVNBP reaching £408 million (YE16: £301 million) at YE17. As of YE17 Royal London reported a slightly negative new business contribution of £5.3 million for its consumer business after being positive for the first time in 2016 (£4.3 million).

At H1 18, PVNBP on life and pensions business was flat at £6,077 million with increases in personal pension and protection sales largely offsetting reduced group pension sales resulting from the end of auto enrolment roll out.

While Royal London has traditionally operated under a multi-brand strategy, the Group has rebranded under a single “Royal London” brand since 2015. We believe this has driven stronger customer recognition over time with limited disruption in distribution channels.

Distribution: Adequate market position with high reliance on IFAs

Moody's views distribution as adequate given Royal London's high reliance on the IFA channel and modest market share. We expect Royal London to keep achieving strong growth in its recently established direct to consumer division, although sales volumes are still relatively modest.

In addition, Royal London has experienced substantial growth in group pensions following the introduction of auto-enrolment and is well placed to benefit from the increase in contribution rates planned for 2018 (to 5%) and 2019 (to 8%). Royal London also owns the Ascentric wrap platform which has been growing substantially over the years and had £15.1 billion of assets under administration as at H1 18 (YE17: £14.4 billion).

Product Risk and Diversification: Business profile predominantly oriented towards unit-linked products and higher margin protection lines

Product risk has been relatively low as Royal London has in recent years written a large proportion of unit-linked business without material guarantees along with protection lines, although the back book does still contain some higher-risk with-profit products. The ability to share risk with policyholders, especially by adjusting terminal bonuses, mitigates this guarantee risk to an extent, subject to floor guarantees. Having said that the with-profit back book still contains substantial guarantees, Moody's notes that the change in the investment strategy in the RL open fund and closed with-profit fund implemented after the financial crisis in 2008 reduced the cost of guarantees.

Royal London's liability profile is predominantly oriented to unit-linked at around 50% of liabilities at YE17, albeit still lower than the 61% of liabilities at YE12. The reduction in the weight of unit-linked liabilities reflects the growth in participating liabilities following the acquisition of CIS. We believe that the ability to share risk with policyholders in CIS' closed-fund in stressed scenarios is meaningful and there remains limited burn-through risk for Royal London.

Asset Quality: Significant exposure to equities and real estate, partially mitigated by product profile and asset-liability management

Moody's considers asset quality to be a relative credit weakness for the Group's ratings, notwithstanding meaningful improvements since the financial crisis in 2008, thanks to a more prudent investment strategy based on asset hypothecation and life-styling strategy.

Royal London's high risk asset ratio as a proportion of unallocated divisible surplus increased in recent years (YE17: 550%, YE12: 219%) following the acquisition of the CIS closed fund in April 2013. However, Moody's notes that this ratio does not include the economic surplus in the closed-funds (including CIS) which we regard as robust with limited burn-through risk in stressed scenarios. Furthermore, we note that the level of investment risk is partially mitigated by the participating nature of the liabilities in the various funds and the potential management actions that can protect the solvency of the various fund in stress scenarios.

Additionally, the amount of intangibles (mostly value in-force of acquired closed books) as a percentage of Moody's adjusted unallocated divisible surplus has reduced gradually over the years to 15.8% in 2017 (YE16: 20.1%) driven by strengthening in capitalisation and gradual amortisation of the acquired value of in force, following the CIS acquisition.

Capital Adequacy: Strong and relatively resilient to market volatility

Moody's views Royal London's economic capitalisation as strong. Royal London has adopted the standard formula approach for the purposes of measuring regulatory capital under Solvency II (SII) from 2016. The Group reported a regulatory Solvency II coverage ratio of 156% at YE17 (YE16: 153%), which translates into a surplus of £2.4 billion. However this ratio (which reflects the capital strength of both the open funds and the closed funds) does not include the excess capital within the closed funds (YE17: £3 billion). This buffer can only be utilised for the benefit of the closed fund policyholders, hence the restriction in the reported ratio. When ignoring the closed funds, Royal London reported a SII coverage ratio of 223% for its open fund at YE17 (YE16: 206%) which we view as strong. At H1 18, Royal London reported regulatory and open fund ratios of 156% and 214% respectively.

The capital position is further supported by relatively limited sensitivity to market movements, as evidenced by reported sensitivities as at 31 December 2017. In particular, a 100bps drop in interest rates would reduce the regulatory SII coverage ratio surplus by £255 million, whereas a decline in equities by 25ppts would reduce the surplus by £41 million.

Overall, Moody's views Royal London's position as relatively strong for capital adequacy. This capital strength is a key underpin of the rating and therefore any material deterioration in this position would be a major credit negative.

Profitability: Improved underlying operating profits, driven by strong new business contribution

Moody's views the Group's profitability as good, albeit vulnerable to volatility in financial markets materially affecting its bottom line results. From an operating perspective, Royal London can benefit from growth in income drawdown and individual pensions after pension reforms given the very limited business volumes of annuities. Its group pension business is also well placed to benefit from the rise in contribution rates scheduled for 2018 and 2019, although group pension sales have reduced significantly during 2018 following the end of auto enrolment roll out. Nevertheless we believe the Group's profitability can be vulnerable to political and regulatory headwinds and competitive pressure in the UK life market.

Royal London reported good operational results in 2017, with EEV operating profit increasing to £329 million (YE16: £282 million). This reflected strong growth in new business contribution (NBC), primarily driven by the strong improvement in volumes of pension business the new business margin (NBM) of which was stable at 2.2%. NBC for protection business also improved although was constrained by the NBM reducing to 6.2% (YE16: 6.6%) as a result of competitive market pressure. On a bottom-line basis, Royal London reported an EEV profit after tax of £414 million compared to a loss of £21 million in 2016 which was negatively affected by a one-off charge (£182 million) in relation to model adjustments in light of SII implementation.

IFRS result before tax and transfers to unallocated divisible surplus grew to £455 million (2016: £325 million). Excluding the above mentioned one-off charge in 2016 (£165 million on IFRS basis), the IFRS result before tax and transfers to unallocated divisible surplus was slightly down in 2017. The transfer to the unallocated divisible surplus (UDS) significantly increased to £352 million (2016: £76 million) .

The 5-year return on capital (ROC, as measured by transfers to UDS) averaged 5.4% with the 1-year ROC up to 6.6% in 2017 (2016: 3.3%). The overall profitability metric is constrained by the high volatility of the bottom line which is in turn driven by a high correlation with investment performances. However, Moody's notes that this volatility is exacerbated by the mutual status of the company because the investment volatility in the with-profit fund affects directly the IFRS income statement.

At H1 18, Royal London reported EEV operating profit of £187 million representing a 1% increase although this rises to a strong 21% excluding a one-off benefit in 2017. This is notwithstanding a 5% reduction in NBC impacted by the reduced group pension sales. The transfer to the UDS increased by 2% to £196 million.

Liquidity and Asset/Liability Management: Strong liability and sound ALM capabilities

Liquidity scores very highly due to the large volume of frequently traded assets on the balance sheet. Moody's views the ALM capability as sound and aligned with an AA rating, although not amongst the market leaders.

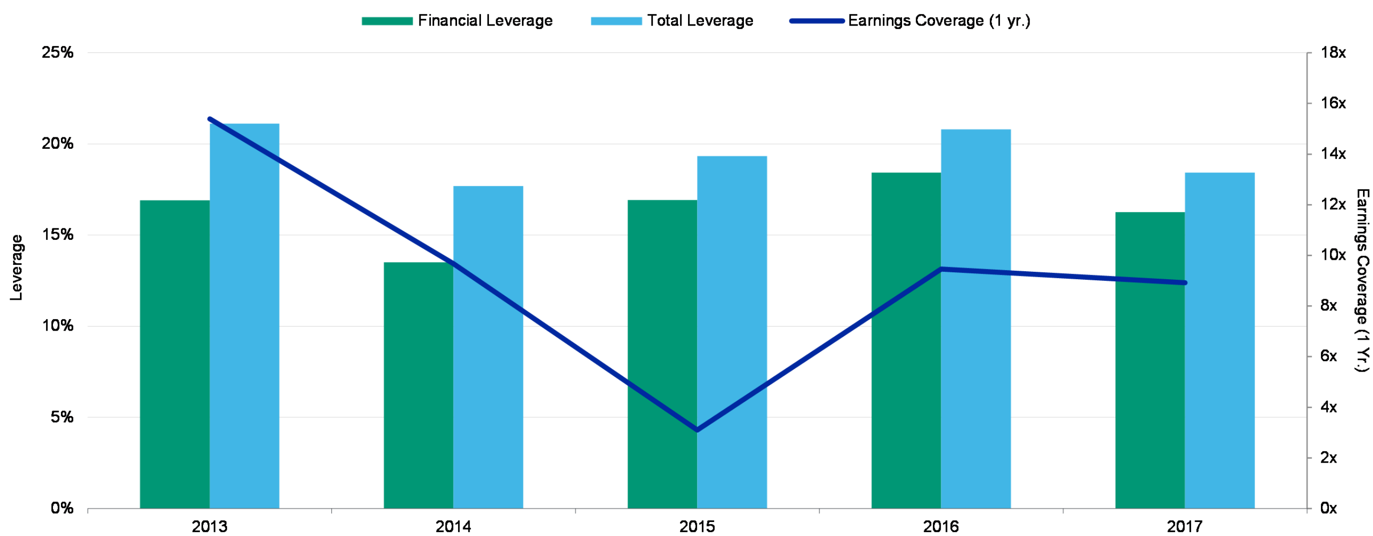
Financial Flexibility: Good metrics offset by more limited ability to access markets as a result of the mutual legal status

Overall Moody's views Royal London's financial flexibility as good for the rating level. Like most mutuals, financial leverage has been consistently low, nevertheless the company's financial flexibility is somewhat constrained by the expectation of limited access to capital markets in stress scenarios. Going forward we expect Royal London's financial flexibility ratios to increase, given its improving profitability and therefore an increasing UDS.

The issuer most recently accessed the debt capital market in 2015, upon issuing £350 million subordinated notes with a bullet maturity of 13 years. The impact on the leverage metrics was modest as the debt issuance was effectively pre-financing the outstanding £245 million subordinated notes that the company redeemed at first call in the same year. At YE17, Moody's financial and total leverage reduced modestly to 16.3% and 18.4% (YE16: 18.4% and 20.8% respectively), reflecting a strong increase in UDS by 13% to £3,726 million.

The 5-year average earnings coverage has decreased to 9.3x in 2017 (2016: 11.0x), as the earnings coverage of 2012 (17.4x) was excluded from the calculations. The one-year earnings coverage reduced to 8.9x in 2017 (9.7x in 2016).

Exhibit 3
Financial Flexibility



Source: Company reports and Moody's Investors Service

Rating methodology and scorecard factors

Exhibit 4

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								Baa	A
Market Position and Brand (15%)								A	Baa
- Relative Market Share Ratio			X						
Distribution (10%)								Ba	Baa
- Distribution Control					X				
- Diversity of Distribution					X				
Product Focus and Diversification (10%)								A	Aa
- Product Risk	X								
- Life Insurance Product Diversification					X				
Financial Profile								Baa	A
Asset Quality (10%)								B	Baa
- High Risk Assets % Shareholders' Equity							549.8%		
- Goodwill & Intangibles % Shareholders' Equity	15.8%								
Capital Adequacy (15%)								B	Aa
- Shareholders' Equity % Total Assets						1.8%			
Profitability (15%)								Baa	A
- Return on Capital (5 yr. avg)			5.4%						
- Sharpe Ratio of ROC (5 yr. avg)				162.7%					
Liquidity and Asset/Liability Management (10%)								Aaa	Aa
- Liquid Assets % Liquid Liabilities	X								
Financial Flexibility (15%)								Aa	A
- Financial Leverage		16.3%							
- Total Leverage		18.4%							
- Earnings Coverage (5 yr. avg)		9.3x							
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Baa1	A2

[1] Information based on IFRS financial statements as of Fiscal YE December 31

[2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis

Source: Company reports and Moody's Investors Service

Structural considerations

Moody's ratings of the subordinated bonds at RL Finance Bonds No. 2 and RL Finance Bonds No. 3 plc are driven by the A2 Insurance Financial Strength rating of Royal London. The notching between the A2 IFSR and the Baa1 debt rating is two notches, reflecting the guarantee provided by Royal London and Moody's standard notching procedures.

Ratings

Exhibit 5

Category	Moody's Rating
THE ROYAL LONDON MUTUAL INSURANCE SOCIETY LTD	
Rating Outlook	STA
Insurance Financial Strength	A2
SCOTTISH LIFE FUND	
Rating Outlook	STA
Insurance Financial Strength	A2

Source: Moody's Investors Service

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