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Ratings

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Royal London Mutual Insurance Society Ltd.

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Royal London Mutual Insurance Society Ltd.

Ratings	
Issuer Credit Rating	A/Stable/--
Subordinated Notes*	BBB+

*Guaranteed by Royal London Mutual Insurance Society Ltd.

Major Rating Factors

Strengths

- Profitable operations that support future business growth and capital requirements.
- Significant levels of capital, supplemented by strict capital management policies.
- Strong market position and brand name in the U.K. life market.

Weaknesses

- Although diverse within the UK life industry, the portfolio is relatively concentrated in terms of geography and sector.
- Mutual status weighs on its financial flexibility because a mutual cannot raise equity capital.
- Subject to potential volatility that could stem, for instance, from its large defined benefit pension scheme or with-profit funds.

Rationale

Our ratings on Royal London Mutual Insurance Society Ltd. (Royal London) reflect its stable operating performance and growth trend, despite the potential for volatility; its high levels of capitalization; and its strong brand and market position in the U.K. life sector. The mutual's resilient financial profile and strong risk controls therefore lead us to choose the higher of the two anchors, 'a' and 'a-'. The mutual has a more focussed geographic and sector portfolio compared to higher rated peers, which tend to have diverse operations. We also view as limiting factors the potential capital and earnings risks from the sizable pension scheme and indirect exposure to equities through its with-profits funds.

While we expect Royal London to generate sufficient earnings to meet future capital needs, as a mutual it has limited external sources of capital and liquidity as it cannot access the equity markets. It maintains high liquidity levels by adjusting assets to meet projected cash requirements.

Outlook: Stable

Our outlook on the ratings is stable. Over the next two years we expect Royal London to:

- Profitably diversify and build scale by increasing the contribution from its wealth management operations, and by continuing to develop its protection and direct propositions;
- Maintain life and pensions new business margins around or above 2%; and
- Preserve its high quality balance sheet and maintain strong risk controls.

Downside scenario

We could lower the ratings if:

- Royal London's competitive position and market share deteriorates compared to peers, for example if its brand position weakens;
- We observe a drop in profitability from which we do not anticipate a recovery, for example from increased pressures on prices;
- We no longer assess capital and earnings as very strong, because of a substantial reduction in capital or a radical change in risk profile; or
- We lower our opinion of Royal London's financial flexibility, for example because of low fixed-charge coverage ratios.

Upside scenario

Our assessment of Royal London is constrained by its relatively narrow product profile and lack of geographic diversification compared to higher rated peers across Europe. As a result, we do not expect to raise the ratings during the next two years.

Base-Case Scenario

Macroeconomic Assumptions

- U.K. economy is likely to underperform many of its advanced economy peers over the forecast horizon, growing on average by 1.5% over 2019-2021.
- Over the forecast horizon through 2021, we expect that the BoE's stance will remain relatively accommodative and interest rate increases will be very gradual.
- For more macroeconomic assumptions please refer to "Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative," published April 28, 2018

Company-Specific Assumptions

- The value-of-life new business margins to remain around or above 2%, driven by a more profitable product mix from higher protection and direct-to-consumer sales.
- Group capital adequacy to remain at least very strong.
- Earnings (transfer to unallocated divisible surplus) to be at least £100 million-£150 million over the next two years.
- Leverage ratio to remain below 30% and fixed charge coverage ratio above 4x over the next two years.

Key Metrics

	2019f	2018f	2017	2016	2015	2014
Gross Premiums Earned (mil. £)	>1300	>1300	1,239	1,291	1,194	1,218
Net Income i.e. transfer to UDS (mil. £)	100-150*	100-150*	352	76	125	149
Life New Business Margin (%)	c.2	c.2	2.4	2.5	2	1.4
Total New Business Margin (%)	c.2.6	c.2.4	2.8	2.5	2	1.4
Fixed-charge coverage	>4	>4	12.6	10.5	5.4	6.9

f--Forecast. Total New Business Margin includes RLAM. *Excludes the impact from one-off accounting charges

Business Risk Profile: Strong

In our view, Royal London faces low overall industry and country risk because of the U.K.'s sound institutional framework and the life insurance sector's strong track record of minimizing asset-liability mismatches. We consider the U.K.'s life insurance sector to be highly competitive, but believe that, despite this, it has maintained moderate levels of profitability.

Royal London stands out as one of the few major mutual insurance companies still operating in the U.K. It has sustained its strong position and market share in the U.K. life market throughout the pensions and insurance reforms in the industry. In addition, Royal London benefits from a strong and long-standing relationship with intermediaries, helped by its focus on the midsize market. We expect the group to continue to profitably grow new business volumes in its insurance operations by leveraging its culture of customer service.

Significant growth in funds under management (both organically and inorganically) has eased cost pressure compared with previous years, as seen in stronger margins in the pension business. However, the group is still behind the biggest players in the U.K. market in terms of scale. We expect Royal London to remain focussed on disciplined pricing and profitable growth, to ensure it remains competitive.

Intermediary pensions accounted for £363 million of EEV operating profit before tax and will continue to be the largest profit contributor for Royal London. As auto-enrolment tapers off, we expect the group to build on its drawdown proposition for future sales. Protection sales (present value of new business premiums) increased by 25% in 2017 and growth in new business volumes will add diversity to the group's sources of revenue. That said, we expect intense competition on prices from larger peers to lead to margin pressure for the protection business.

Royal London has also developed direct to consumer and business propositions. Although we see it as a positive in terms of diversification, we expect that it will contribute only marginally to the group's profit.

We expect Royal London's external wealth management operations through Royal London Asset Management Ltd. (RLAM) to continue to support Royal London's traditional insurance business lines.

We believe that the vote in favor of Brexit will not materially affect Royal London's competitive position because the majority of its business is generated from within the U.K.

Financial Risk Profile: Strong

Royal London benefits from substantial capitalization, relative to the risks it faces. Despite low yields and the company's exposure to equities through its with-profits funds, we expect the bonus flexibility in this product line to enable the group to maintain its capital and earnings.

For the U.K. with-profits business, our capital charges are based on information provided under the regulatory realistic balance sheet framework. With the introduction of Solvency II, insurers no longer perform this valuation, but provide financial information reflecting the risks relating to with-profits business in accordance with Solvency II rules. We use Solvency II, insights from existing realistic balance sheet calculations, and other information provided to derive the capital model inputs for this business.

Although the group's mutual status means that the reported net income is zero, we analyze the transfer to unallocated divisible surplus (UDS) as a proxy for profit. We expect the transfer to UDS to be at least £100 million-£150 million a year over the coming few years. Low interest rates and market movements remain key sensitivities for our earnings forecasts, and these factors can have a material effect on the transfer.

Partly offsetting our view of the financial strength is the potential volatility that could arise from the mutual's sizable pension scheme: £3.1 billion as of FY2017. It is therefore exposed to longevity risks. We also factor in the volatility associated with the material amount of equities held within its with-profits funds. However, we believe that this exposure is somewhat mitigated by the flexibility in the funds' profit-sharing structure.

We consider that Royal London's mutual status weighs on its financial flexibility because a mutual cannot raise equity capital. As a result, Royal London's main source of external funding is debt issuance with an established track record in subordinated debt, including in late 2013 and 2015. We expect fixed-charge coverage to remain above 4x for the next two years.

Other Assessments

Risk management is well embedded within the group. The group risk appetite statement is set by the board and reviewed annually. Asset liability management (ALM) processes are used to ensure that RLAM has set appropriate investment parameters for each fund. RLAM, in turn, has a comprehensive set of investment risk controls. Exposure to mortality and, to a lesser extent, morbidity experience is limited through reinsurance with highly rated reinsurers.

Our assessment of management and governance is supported by a relatively low appetite for financial risk and a robust track record of achievements. We take a positive view of Royal London's recent ability to grow its protection sales, as well as its long-term strategic intent to diversify distribution so that it is less dependent on intermediaries. In our view, this makes sense within the context of the U.K. market, where the use of intermediaries is declining.

Royal London's liquidity is supported by the strength of available liquidity sources. Mechanisms for managing liquidity risk include maintaining forecasts of cash requirements and adjusting assets to meet those requirements.

Accounting Considerations

The accounts have been prepared under IFRS (International Financial Reporting Standards) since 2006, with supplementary embedded value (EV) reporting based on EEV principles.

Rating Score Snapshot

Issuer Credit Rating A/Stable/--

Anchor a

- Business Risk Profile Strong
- IICRA* Low Risk
- Competitive Position Strong

Financial Risk Profile Strong

- Capital and Earnings Very Strong
- Risk Position Moderate Risk
- Financial Flexibility Adequate

Modifiers 0

- ERM and Management 0
- Enterprise Risk Management Adequate With Strong Risk Controls
- Management and Governance Satisfactory

- Holistic Analysis 0

Liquidity Exceptional

Support 0

- Group Support 0
- Government Support 0

*IICRA--Insurance Industry And Country Risk Assessment.

Related Criteria

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- 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
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Criteria - Financial Institutions - Banks: Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings Detail (As Of July 20, 2018)	
Operating Company Covered By This Report	
Royal London Mutual Insurance Society Ltd.	
Counterparty Credit Rating	
Local Currency	A/Stable/NR
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.