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Liverpool Victoria Group

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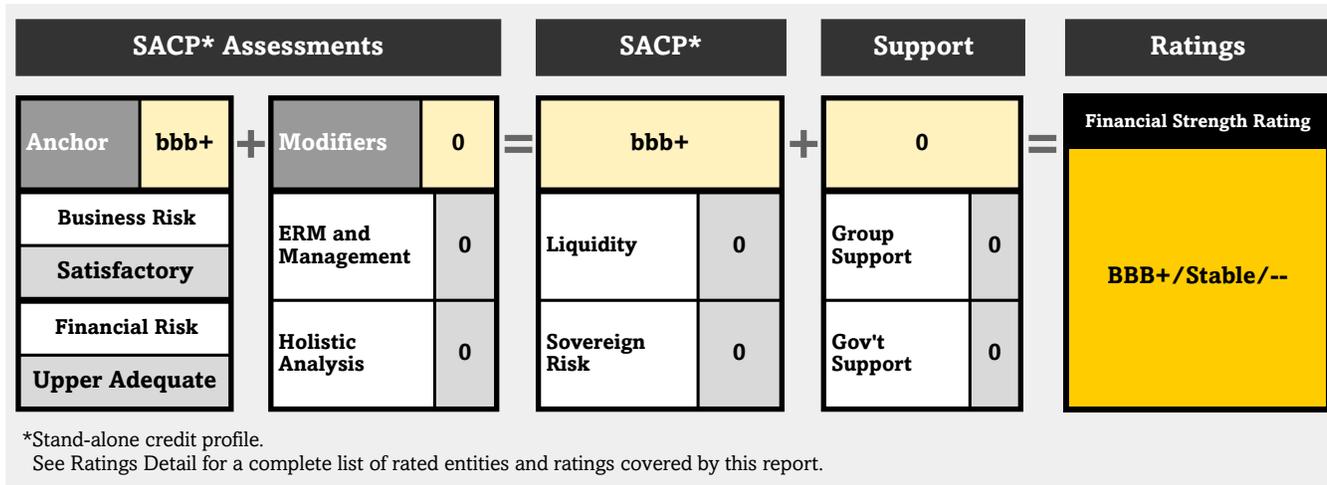
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Liverpool Victoria Group

(Editor's Note: The ratings score snapshot graphic below refers to Liverpool Victoria Friendly Society Ltd. See "Ratings Score Snapshots" section at the end of the report for Liverpool Victoria Insurance Co. and Highway Insurance Co. Ltd.)



Major Rating Factors

Strengths:

- Established brand offering life and non-life products, albeit in concentrated segments in the U.K. markets.
- Proceeds from the sale of the general insurance (GI) business will strengthen capital adequacy.

Weaknesses:

- Operating performance sensitive to market and economic events, particularly for the life business.
- Volatile capital and earnings weighs on Liverpool Victoria Friendly Society's (LVFS) risk assessment; GI operations have demonstrated a steady ability to generate earnings.
- LVFS faces limited sources of external financial support and high debt obligations; the GI business benefits from a largely debt-free balance sheet.

Rationale

Our ratings on Liverpool Victoria Friendly Society (LVFS) reflect its strong capital position, offset by the potential for volatility of capital and earnings. The sale of 49% of the GI operations has strengthened LVFS' capital adequacy but weakened its competitive position as it now relies more on the less profitable life operations to generate capital.

The GI operations have demonstrated a track record of stable and profitable operating performance. Their business also benefits from a well established brand and a strong market position in the U.K. motor market. These factors are offset by the portfolio's high reliance on the motor sector for revenues and profits, which further exposes it to volatility stemming from industry events.

Outlook: Stable**Liverpool Victoria Friendly Society (LVFS)**

The stable outlook on LVFS reflects our view that its capital adequacy will strengthen as a result of this transaction and stabilize thereafter. We believe that it will be challenging to improve the business profile of the life operations given the competitive market conditions but expect that LVFS will maintain and profitably build on its competitive position through investment in its brand and network.

We could lower the ratings over the next two years if:

- LVFS' business profile and market share of life operations deteriorates compared with peers, or if the operations are unable to sustainably generate competitive returns;
- We see a substantial deterioration in capital or a radical shift in risk profile that weakens LVFS' capital and earnings; or
- LVFS' financial flexibility weakens, for example, because insufficient capital or liquidity is available, relative to current and future needs.

We consider an upgrade unlikely over the next two years. Our ratings on LVFS are more exposed to the potential downside risks that would arise if it is unable to develop the life franchise sustainably. The combination of a constrained business profile and reduced earnings capacity gives LVFS less of a buffer in our assessment of its credit profile than we previously assumed.

Liverpool Victoria Insurance Co. (LVIC) and Highway Insurance Co. Ltd. (HICO)

The positive outlooks on LVIC and HICO reflect our expectation that these companies will benefit from becoming part of the Allianz group (core operating subsidiaries rated 'AA/Stable'). As group members, they could have access to strong levels of capital and liquidity support. Over the next two years, we expect the Allianz group will take more control, albeit indirectly, of the strategic direction of the GI operations. We expect that the Allianz group will become the majority stakeholder, gaining strategic control of LVIC and HICO no later than Dec. 31, 2019.

In our base-case scenario, we anticipate that the GI operations will preserve its capital adequacy and maintain its market share and profitable operating performance.

We could raise the ratings by one notch or more if we assess LVIC and HICO as being of strategic importance to the Allianz group.

We could revise the outlook to stable if:

- We consider that LVIC and HICO are nonstrategic or moderately strategic to the Allianz group after the transaction closes;
- The transaction doesn't proceed under the planned terms and conditions; or
- The group credit profile of the GI business deteriorates.

We could lower the group credit profile on the GI operations if:

- The competitive position and operating performance of the GI operations deteriorates compared with peers, or if its market share weakens; or
- The capital and earnings weakens significantly below the 'BBB' level, because of a substantial deterioration in capital versus future requirements, or if the risk profile deteriorates substantially.

Base-Case Scenario

Macroeconomic Assumptions

- The U.K. economy is likely to underperform many of its economically advanced peers increasing, on average, by 1.5% over the 2019-2021 forecast horizon.
- Over the forecast horizon through 2021, we expect that the Bank of England'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 27, 2018.

Company-Specific Assumptions

- Life and GI operations will maintain their competitive position, supported by life margins of about 2% and non-life combined (loss and expense) ratio of below 97% over 2018-2020.
- Proceeds from the divestment will help LVFS maintain an upper adequate financial risk profile over 2018-2020.
- The GI operations will preserve its capital adequacy and maintain market share and profitable operating performance.
- The Allianz group will become the majority stakeholder, gaining strategic control of LVIC and HICO no later than Dec. 31, 2019.

Key Metrics

(Mil. £)	2019f	2018f	2017	2016	2015	2014
New business margins on PVNBP basis (life) (%)	c.2	c.2	1.8	1.6	1.6	1.0
Combined ratio (non-life) (%)	<97.0	<97.0	91.7	105.8	96.1	96.1
Fixed charge coverage (x)	<4	<4	6.9	N.M.	6	3
LVFS Financial risk profile	Upper Adequate	Upper Adequate	Upper Adequate	Upper Adequate	Moderately Strong	Moderately Strong

f--Forecast. PVNBP--Present value of new business premiums. N.M.--Not meaningful.

Company Description

LVFS is a U.K.-based friendly society and is a mutual life insurer focused on the protection and retirement sector. It is the parent of two limited-liability GI companies, Liverpool Victoria Insurance Co. Ltd. (LVIC) and Highway Insurance Co. Ltd. (Highway), both of which focus on the motor market. On Aug. 4 2017, LVFS announced a strategic partnership with Allianz to sell a 49% stake in its GI operations to Allianz in December 2017, subject to regulatory approval. It will sell a further 20.9% stake in December 2019. The GI operations consist of LVIC and HICO. After the December 2017 sale, LVFS will also have a put option on its remaining stake in the GI business.

We regard the life operations of LVFS as core to the LVFS group and LVIC and HICO as core to the GI operations. However, we consider the GI business to be nonstrategic to LVFS due to LVFS' declining control over the GI operations and the shift of its strategic focus toward life operations. As a result, the ratings on LVIC and HICO will not benefit from any parental support from LVFS.

Our issue rating on LVFS' subordinated debt is 'BBB-'.

Liverpool Victoria Friendly Society (LVFS)

Business Risk Profile: Satisfactory

LVFS' life strategy is based on exploiting profitable niches, product adjacencies, and targeting an affluent demographic at, and beyond, retirement age. The mutual insurer has a well-recognized brand and a strong market presence in the individual income protection sector. However, the life segment's results have often been depressed by market movements, which constrains our assessment. We consider that the divestment of the GI business will weaken LVFS' competitive position because it will concentrate the business profile on the less profitable, more volatile life business, although not to the extent that we revise our assessment.

At half-year (HY) 2018, total life new business in terms of the present value of new business premiums decreased by 5% to £983 million and new business contribution was down 30% to £14 million. The decline partly reflects the slowdown in pensions and restructuring of the protection portfolio toward individual income protection and term assurance.

In our view, LVFS will find it difficult to improve profitability and build a sustainable market position in the life business, given the tough competition it faces. Successful implementation of strategic objectives and the ability to competitively develop and stabilize the life operations will be vital over the next two-to-three years.

Prospectively, we expect that LVFS will retain its sound position in individual income protection and will profitably expand its pensions and other protection products. We anticipate that LVFS will deploy its brand and distribution network to build up scale and improve margins in its life operations.

Financial Risk Profile: Upper Adequate

We anticipate that LVFS will retain the proceeds from the non-life divestment over the 2018-2020 forecast period, which will strengthen its capital adequacy and alleviate some of the recent capital pressure. As a result, we expect LVFS to maintain strong capital and earnings over 2018-2020.

That said, the sale will constrain LVFS' ability to organically build up capital for future growth while servicing its financial obligations. Earnings will likely fall after the transaction because the non-life operations were generating a significant proportion of the group's earnings. The scale of the balance sheet and reliance on soft capital such as hybrids and value-in-force limit our assessment.

In recent years, LVFS has witnessed significant variations in both capital and earnings. The past levels of retained earnings have proven insufficient to adequately reinforce the balance sheet to be able to withstand market impacts. We consider earnings to be susceptible to external regulatory or legislative pressures. Additionally, LVFS has a relatively high defined-benefits pension liability and the investment portfolio is concentrated in the financial sector. High potential sources of capital and earnings volatility therefore constrain our overall assessment of the financial risk profile.

We expect that debt coverage metrics will decline because LVFS' earnings capacity will be reduced by the sale of part of its GI business. Earnings will likely fall after the transaction because the non-life operations were generating a significant proportion of the group's earnings.

In our opinion, LVFS has limited sources of external capital and liquidity. The £350 million hybrid issue in May 2013 raised the proportion of capital, accounted for by hybrids, to above our 25% ceiling for inclusion in total adjusted capital. Consequently, we would not give capital credit for any further debt issues. Further, as a mutual insurer, LVFS does not have the option of raising funds through equity issuance.

Liverpool Victoria Insurance Co. (LVIC) and Highway Insurance Co. Ltd. (HICO)

Business Risk Profile

We assess the GI operations to have an adequate competitive position supported by a track record of stable and profitable operating performance. The operations also benefit from a well-established brand and from being the fourth-largest personal motor insurance provider in the U.K. by premium. Offsetting these factors is the portfolio's high reliance on the motor sector for revenues and profits. This exposes the GI business to volatility stemming from industry events, as recently demonstrated when the U.K. lowered its Ogden discount rate.

At HY 2017, the higher reported combined ratio 95.7% (HY 2018: 93.6%) and reduced operating profit of £23 million (HY 2017: £49 million) were hit by higher weather-related claims and lower investment returns. We anticipate that the GI business will retain its strong motor market position and remain profitable, with a combined ratio of below 97%

over 2018-2020.

Financial Risk Profile

We expect the GI operations to generate sufficient earnings to cover growth requirements and that the capital position will not deteriorate significantly below the 'BBB' level, under the S&P Global Ratings model, over 2018-2020.

We consider that the GI operations have lower sources of potential volatility. Over the past five years, the business has consistently generated stable returns. While investment assets are largely invested in highly rated bonds, the portfolio is concentrated toward the financial sector, which increases market exposure.

We assess the GI business as having adequate financial flexibility due to limited financial obligations given its largely debt-free balance sheet.

Other Assessments

Risks are actively mitigated while risk controls are clearly supported by risk policies. LVFS manages its asset liability management and market risks using financial derivatives along its granular risk limit structure. Additionally, risks associated with reserving and claims management are mitigated using reinsurance, and systematically managed through internal and external reviews. LVFS' risk appetite is well defined but was pressured in 2016 as LVFS' capital position deteriorated below target levels. Following the sale of the GI business, we anticipate that risk governance and risk reporting will remain sound despite the enterprise risk management framework being expected to slightly evolve.

Rating Score Snapshots

Liverpool Victoria Friendly Society Ltd.

Counterparty Credit Rating: BBB+/Stable

Anchor: bbb+

Business Risk Profile: Satisfactory

- Industry and country risk: Low risk
- Competitive position: Adequate

Financial Risk Profile: Upper Adequate

- Capital and earnings: Strong
- Risk position: Moderate risk
- Financial flexibility: Less than adequate

Modifiers

- Enterprise risk management: Adequate with strong risk controls
- Management and Governance: Fair
- Holistic analysis: 0

Liquidity: Exceptional

Group support: 0

Government support: 0

Liverpool Victoria Insurance Co. / Highway Insurance Co. Ltd.

Group Credit Profile: BBB+/Positive

Anchor: bbb

Business Risk Profile: Satisfactory

- Industry and country risk: Intermediate risk
- Competitive position: Adequate

Financial Risk Profile: Lower adequate

- Capital and earnings: Lower adequate
- Risk position: Intermediate risk
- Financial flexibility: Adequate

Modifiers

- Enterprise risk management: Adequate with strong risk controls
- Management and Governance: Satisfactory
- Holistic analysis: +1

Liquidity: Exceptional

Group support: Nonstrategic

Government support: 0

Related Criteria

- 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 September 25, 2018)

Operating Companies Covered By This Report

Liverpool Victoria Friendly Society Ltd.

Financial Strength Rating

Local Currency

BBB+/Stable/--

Issuer Credit Rating

Local Currency

BBB+/Stable/--

Subordinated

BBB-

Highway Insurance Co. Ltd.

Financial Strength Rating

Local Currency

BBB+/Positive/--

Liverpool Victoria Insurance Co. Ltd.

Financial Strength Rating

Local Currency

BBB+/Positive/--

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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