STANDARD & POOR'S

FULL ANALYSIS

Liverpool Victoria General Insurance Group

Financial Strength Rating

Local Currency
BBB+/Stable/—

Primary Credit Analysts:
Simon Ashworth
London
(44) 207176 7243
Simon_Ashworth@
standardandpoors.com

Secondary Contacts: Nigel Bond
London
(44) 20-7176-7063
nigel_bond@
standardandpoors.com

Mark Button
London
(44) 20-7176-7045
mark_button@
standardandpoors.com

Additional Contact: Insurance Ratings Europe
InsuranceInteractive_Europe@standardandpoors. com

RatingsDirect Publication Date

Nov. 1, 2011

Major Rating Factors

Strengths:

- Improving competitive position, following rebranding and repositioning.
- Good capitalization.
- Strong investment profile.

Weaknesses:

- Low, but improving, levels of historical operating performance.
- Relatively concentrated exposure within U.K. non-life insurance and exposure to more specialist U.K. life insurance products and risks.
- Competitive operating environment across the U.K. insurance sector.

Rationale

The ratings on U.K.-based non-life insurers Liverpool Victoria Insurance Company Ltd. (LVIC) and Highway Insurance Company Ltd. (Highway), which are part of Liverpool Victoria General Insurance Group Ltd. and are core entities of U.K.-based Liverpool Victoria Friendly Society (LVFS), reflect the relative strengths and weaknesses of the group (LVFS). Standard & Poor's considers the strengths to be LVFS' improving competitive position, good level of capitalization, and its strong investment profile. Constraining factors are current and historical operating performance, and the relatively concentrated exposure to both the motor market within the non-life space and more specialist life insurance products. In addition, the group is fully exposed to the U.K. insurance operating environment and future changes in its competitive landscape.

We consider the strengthening of the group's competitive position since 2006 to be positive for the rating. The group has predominantly focused on repositioning toward products aligned with its strategic aims in the life and non-life insurance markets, and obtaining a top-five position in these chosen markets. In addition, there has been a focus on improving group brand awareness, further strengthening the management team, and improving efficiency. We expect to see LVFS' position in its chosen markets strengthen further over the rating horizon.

We assess overall capitalization as good, which is supported by the group's high quality of capital. This includes very low levels of financial leverage and limited reliance on value-in-force (VIF). We anticipate that prospective cash generation and future management actions aimed at lowering the exposure of LVFS' balance sheet to certain risks will strengthen capitalization.

We consider LVFS' investment profile to be strong, well-diversified, and appropriate for its liabilities. The risk in the life insurance investment portfolio has been lowered in recent years to be more in line with that of peers, and the credit quality of the bonds backing these liabilities is high. The nature of the assets backing the non-life business is also appropriate for the liability types, in our view.

The predominant constraint on the rating is current operating performance. Although earnings continue to improve, this remains a rating weakness. LVFS exhibits diversity in terms of earnings provided by the composite business model. However, this is somewhat offset by the concentration on the motor insurance market within the non-life insurance space and the smaller and more-specialist markets in the life insurance space. The concentration within the U.K. market exposes the group to the current competitive and challenging operating environment.

Outlook

The stable outlook reflects our expectation that LVFS will maintain its current competitive position in its chosen markets and its good capital position. These are both rating strengths. We also expect operating performance to be resilient, despite prospective changes to conditions in both the non-life and life insurance markets.

A positive rating action on LVIC and Highway may be taken if:

The group improves its financial profile by continuing to improve operating performance in all business segments. Measurement of this would be based on sustained and significant improvements in operating profits. In particular, this would result from consistently achieving combined operating ratios of below 100%, but also from generating sustained increases in profits from the life business by increasing the scale of new business; and

- The group achieves strong capitalization; or
- The group improves its business profile by further strengthening its competitive position. This would be measured by market share in its chosen markets and also through increased operating profits.

A negative rating action may be taken on LVIC and Highway if LVFS fails to:

- Maintain good capitalization;
- Produce positive trends in operating performance, based on increased operating profits; or
- Maintain its competitive position in its chosen markets.

A negative rating action may also be taken if we no longer assess the non-life operations as core under our group methodology.

Corporate Profile: LVFS Is A Mid-Tier U.K. Friendly Society With A Balanced Life And Non-Life Risk Profile

LVFS is the ultimate parent of LVIC and Highway, which comprise the non-life operations of Liverpool Victoria General Insurance Group (LVGIG). LVFS is a mid-tier U.K.-based insurance company, and had total assets under management of £8.8 billion on Dec. 31, 2010, making it the U.K.'s largest friendly society. Historically, the group has predominantly focused on life insurance but is now an established player in the non-life insurance space, particularly in the motor market. The group has made strategic acquisitions to expand and solidify its presence in this market. For instance, in 1997 the group acquired Landmark Insurance Co. Ltd's motor and household books, in 2007 it acquired Britannia Rescue, and in 2008, it acquired Highway. In addition, in 2007 the group acquired new business capabilities of Tomorrow, which is consistent with its focus on "at retirement" products within the life insurance market. The total gross premium written was approximately £1.9 billion in 2010, split approximately 60% (non-life insurance) and 40% (life insurance).

Competitive Position: Established Player In The U.K. Motor Market, Focused On Specialist Retirement And Protection Solutions In The Life Space

Table 1

Liverpool Victoria Friendly Society Business Statistics (Consolidated)

	—Year ended Dec. 31—			
(Mil. £)	**2010**	**2009**	**2008**	**2007**
Consolidated				
Total GPW	1943.0	1343.0	939.0	669.0
Annual change (%)	44.7	43.0	40.3	—
Total assets	8,848.9	7,519.0	7,554.0	7,922.0
Non - Life				
GPW	1,182.5	811.1	445.1	346.6
Annual change (%)	45.8	82.2	28.4	—
Analysis of GPW				
Motor (%)	82.3	77.3	64.8	60.9
Property damage (%)	9.7	14	25.4	32.5
Other (%)	8.0	8.7	9.8	6.6
Life				
GPW	760.5	532	493.9	322.6
Annual change (%)	43.0	7.7	53.1	—
Participating business (%)	23.5	30.7	28.5	57.4
Non-participating business (%)	74.5	65.8	66.8	34.4
Linked business (%)	2.0	3.6	4.7	8.2

GPW—Gross premium written.

We view LVFS' overall competitive position as good, having improved markedly since 2006. The group has established top-five positions in the majority of its chosen markets across both the life and non-life insurance markets. We have given credit in the assessment of competitive position for the composite business model, which we think enhances the overall business profile of the group. However, the intrA-business line focus on the motor insurance market within the non-life insurance industry, and smaller and more specialist markets in the life insurance industry, does constrain the overall assessment.

Competitive position in non-life

LVGIG is established in the U.K. motor market and was No. 4 overall in terms of written premium as of Dec. 31, 2010, based on FSA returns data. With regards the personal motor market, the group has a solid market position at No.3 as of Dec. 31, 2010, based on data from the Association of British Insurers (ABI). Motor insurance comprises approximately 50% of gross earned premium for the group as a whole and we consider that LVGIG has a solid position in this market. However, given that this is one of the most competitive and cyclical insurance markets, further strengthening of competitive position will be necessary over the rating horizon, to ensure earnings stability over the business cycle.

Non-life distribution channels are diverse and cover different aspects of the direct and broker channels, both of which appear well-managed.

We consider the general insurance business to be core to the group as defined by our group methodology.

Competitive position in life

LVFS is currently well-positioned to maintain its market position in its chosen life insurance markets. These provide diversity from an overall risk exposure perspective. Improvements in group brand awareness and the benefits of cross-selling have strengthened the competitive position. In addition, member discounts are given for non-life insurance products to those holding a member conferring life insurance product. This further enables cross-selling.

Currently the group has a top 3 or better market share in income protection, enhanced annuities, and the equity release markets. That said, these markets remain relatively small and specialist calling for particular expertise and well embedded risk management practices in order to be successful. Moreover, these obstacles are exacerbated by the challenging operating environment across the life insurance industry.

Prospective

Despite the continued growth of the life insurance business, the risk and earnings profile of the group is slowly shifting toward the non-life business. As the earnings profile becomes increasingly dependent on non-life profits, the group will need to strengthen its competitive position within this market.

Management And Corporate Strategy: Good Progress To Date And Continued Focus On Insurance Following The End Of Banking And Asset Management Activities

The ultimate aim of the group is to maximize and diversify returns for its with-profits policyholders. It aims to do this by, for instance, making strategic decisions to provide investment for the growth of the general insurance business, and providing wider benefits to its members.

Strategy

The group's vision for the life business is to be 'the UK's leading protection and retirement solutions specialist' by focusing and excelling in its chosen markets.

The group's vision for the non-life business is to be a top-five player in its chosen market segments. There is a clear focus on improving returns for with-profits policyholders, with defined targets for returns on capital and also on growing "Enterprise Value", which is an internal estimate of an equivalent market value for a quoted company. The group is committed to distributing capital in a manner that is consistent with its mutual beliefs, but that maintains its focus on both profitability and on service standards.

The disposal of the banking operations by 2010 is positive from an overall risk exposure perspective and the outsourcing of the group's asset management function will enable greater focus on the core insurance operations going forward.

The bottom-up strategic planning and forecasting process considers operating performance targets, which are used as performance indicators. These forecasts are tested for resilience under different scenarios, which enables key risks to be better understood.

Operational management

We regard the role of the incumbent management team as integral to the improvements that have been made over recent years. Indeed, we expect further improvements in the operational and management frameworks over the rating horizon. The change in enterprise value is disclosed by LVFS on an annual basis. It is used as a metric for the overall assessment of the added value and contribution of business activities to the overall growth of the group. This change was reported as 30% over 2010, -14% over 2009, and -15% over 2008.

Financial management

The monitoring and management of financial risks has improved over recent years and we anticipate continued developments and enhancements over the rating horizon. This is shown by a lower equity exposure for the with-profits business than in the past. Further evidence of the improvements is the implementation of other de-risking measures across the group, such as the closure of the defined benefit pension scheme to new members, and a reduction in the percentage of equities backing non-life insurance liabilities.

Enterprise Risk Management: Adequate, With Recent Enhancements In Risk Management Culture

The quality of LVFS' enterprise risk management (ERM) framework and the execution of that framework are viewed as adequate. Over the past few years, LVFS has enhanced its ERM framework, particularly with regard to the risk management culture. These enhancements have covered the governance framework, high-level risk appetite articulation, and the enhancement of the management of individual risks. The group is planning to further develop and embed the risk management culture, further enhance the management of individual risks, and also to improve strategic risk management. We understand that the risk appetite will be further cascaded across the different risks over the rating horizon. This is yet to be fully implemented.

We view ERM as being of moderate importance to the ratings on LVFS. The group undertakes a range of complex risks, in particular in the life insurance space. In our opinion, it is possible that any slippage in risk control could lead to a rapid change in retained risk, and possibly losses.

In our view, LVFS' risk management culture is adequate. It has a sound governance structure to sustain and broaden the awareness of risk across the organization. LVFS has established risk policies, which are being embedded across the group and have strengthened the ERM framework. The group has developed a risk appetite framework which delivers a board approved overall risk appetite annually.

We view LVFS' financial risk controls as adequate; the material risk types are measured and managed and risk exposures are frequently monitored. The group has actively taken steps to reduce the exposure to financial risks, in particular market risk, although this remains the largest risk on LVFS' balance sheet.

We view insurance risk controls as adequate. Longevity risk is the most material exposure for LVFS. The group has taken steps to improve the governance around the management of individual insurance risks and has taken some management actions to reduce exposure to longevity risk.

Accounting: Disclosure Improved, Accounts Based On International Financial Reporting Standards

The group has adopted International Financial Reporting Standards for the preparation of its accounts. The group does not report based on European Embedded Value principles. However, it does disclose Enterprise Value, which is an internal estimate of an equivalent market value for a quoted company, and is externally reviewed.

Operating Performance: Improved In Recent Years But Remains A Relative Weakness

Table 2

Liverpool Victoria Friendly Society/Operating Statistics (Consolidated)			
	—Year ended Dec. 31—		
(Mil. £)	***2010***	***2009***	***2008***
Consolidated			
Underlying profit*	96.2	44.2	2.3
General Insurance underlying profit*	30.7	7.0	(30.1)
Statutory profit before tax*	(18.3)	(91.4)	(258.3)
Tranfer (to)/from unallocated divisible surplus (USD)¶	(21.3)	172.2	202.0
Non-life			
Non-life combined ratio§	104.2	104.3	116.7
Life			
Growth in net life insurance liabilities (%)	13.2	9.6	(9.7)

*On an IFRS basis. ¶The amounts that have yet to be formally declared as bonuses for participating policyholders together with the free assets of the group. §Based on company reports and accounts.

Overall operating performance is assessed as good. Both the level and quality of earnings have improved in recent years, albeit from a low base. The improving contribution made by the non-life insurance business provides earning diversity across the group and in 2011 LVFS announced its first mutual bonus for with-profits policyholders. For us, this provides evidence that the group is strengthening operating performance from the trading businesses. However, we continue to view operating performance as a relative rating weakness for LVFS. We base our view mainly on historic non-life CRs and the relatively low, albeit improving, levels of profitability and scale from the new life insurance business.

Historical

Non-life

The level of operating performance from the non-life insurance business should be viewed in the context of the wider U.K. market, in particular the motor market. The U.K. motor insurance market is very competitive, particularly on pricing. As a result, the market's underwriting performance has regularly been poor. From 1983 to 2009, the market in aggregate achieved an underwriting profit in just eight of the 27 years.

Since 2007, there have been significant improvements in CRs for LVGIG. At year end 2010, the CR for the group was 104.2%, down from approximately 120% at year-end 2007. This is a result of a combination of reductions in both claims ratios and expense ratios across the period, due to underwriting changes, synergies from inorganic growth, and economies of scale from organic growth. Removing the impact of extreme weather conditions and reserve releases would have resulted in a CR of approximately 106% at year-end 2010.

In the motor market, the CR for 2010 was among the best of the largest players in the market. The market average was approximately 120%.

Life

The profitability of the life insurance business is improving. This is due to increases in the volume of business and continued operational restructuring, which reduces the expense overruns. Trading profit increased to £30.4 million from £20.6 million from 2009 to year-end 2010. The value of new business also increased. While volumes are growing across the different product segments of retirement, protection, and savings, the overall scale is small compared to other market participants.

Prospective

The repositioning of the business since 2006 has yielded improved results and built the foundations for potential improvements in performance going forward. We expect the overall operating performance for the group to continue to improve over the rating horizon.

The non-life insurance operating performance is well positioned to capitalize on the currently favorable trading conditions. We can see this in CRs of below 100% at half-year 2011. However, the earnings from the non-life insurance business are heavily exposed to changes in the trading conditions in the U.K. motor market. The non-life business is becoming an increasing proportion of the group's earnings over the rating horizon. This may increase the cyclicality of the results for the overall group.

We expect the life insurance operating performance to improve as increases in volume enhance the profitability from the new business. We anticipate that further strengthening of currently strong positions in its chosen markets will yield improvements in both volume and profitability. However, we expect the overall growth in volume to be lower than that generated by the non-life insurance business, given its relative market position and the relative trading environments.

Investments: Strong, Well Aligned To The Risk Profile

Table 3

Liverpool Victoria Friendly Society/Investment Statistics (Consolidated)				
	—Year ended Dec. 31—			
(Mil. £)	*2010*	*2009*	*2008*	*2007*
Non-linked portfolio composition (%)				
Bonds and other fixed interest securities	59.6	47.8	40.9	31.5
Common stock	27.3	33.1	30.0	38.3
Property	3.9	5.7	6.1	9.3
Cash and bank deposits	6.7	11.1	17.7	13.8
Loans and private placements	0.0	0.9	3.9	6.3
Other investments	2.4	1.4	1.4	0.9
Total	100	100	100	100

We consider LVFS' investment profile to be strong, well-diversified, and appropriate for its liabilities. Overall, the group possesses a low-risk investment portfolio relative to its liabilities and capital base. The material exposure to equities is from the with-profits business. This is now more conservative than it has been in the past, following de-risking activities throughout 2010 and the first half of 2011. The group possesses significant flexibility in terms of managing the risks associated with the with-profits business, which is outlined in the capitalization section.

Life

Credit risk

LVFS' fixed-income investment quality is very strong, in our view. It has a high proportion of U.K. government and government-guaranteed securities (60% of fixed- and variable-rate securities at year-end 2010), and highly rated corporate bonds. In total, more than 96% of LVFS' bonds were rated investment-grade at year-end 2010, and the average credit quality of rated fixed-interest assets was around the 'AA' rating level.

Market risk

The group has implemented measures to reduce the overall exposure to market risk over recent years. The monitoring of market risk is formally integrated into the groupwide ERM processes. It is overseen by group risk management and the board investment committee.

With profits payout philosophy

Payouts from the main with-profits fund to reserves held for the claims in the fund was 102% in 2007. However, payouts rose to 128% in 2008. There was an upward trend in payouts in 2008 across the industry but this figure still exceeds the market average. The payouts have since been managed down to 97% in 2009 and to 98% in 2010.

Non-life

The non-life investment portfolio is appropriate for the nature and term of the liabilities. Approximately 90% of the investment portfolio is invested in either government or corporate bonds; 99% of the portfolio is classified as investment grade and 47% of the bonds were rated 'AAA' as of

May 31, 2011. The average duration of the bond portfolio at this date was 2.6 years. The investment mix is currently shifting to further reduce exposure to equities.

Liquidity: Strong, Supported By Investment Portfolio and Risk Policies

We view liquidity as strong due to the proportion of total assets comprised of cash and other liquid assets and the implementation of robust liquidity risk policies and procedures. In addition, the business profile and lack of debt within the group's capital structure support our view. Group level cash and cash equivalents were £536 million on Dec. 31, 2010; this was approximately 6% of total assets.

Liquidity risk arises from both the non-life insurance and the life insurance businesses. The majority of the life insurance liabilities have a term of more than five years. Moreover, almost 50% of new life business is annuity business, and has no surrender risk. LVFS also retains the flexibility to manage liquidity risk for with-profits business via surrender charges and market-value reductions. The assets backing the non-life liabilities are liquid in nature and the risk profile of the non-life insurance business is such that the group is less exposed to liquidity risk, for instance from catastrophes.

At LVFS there are also established risk policies and procedures that explicitly consider liquidity risk identification and monitoring, including stress and scenario testing as part of the wider risk management process.

Capitalization: Assessed As Good, Quality Of Capital Is A Positive Factor

We regard LVFS' overall capitalization as good. Supporting this is the group's high quality of capital, reflecting low financial leverage and limited reliance on VIF. We anticipate that LVFS' capitalization will be strengthened by prospective cash generation and future management actions to further de-risk the balance sheet.

Capital adequacy

LVFS' capital adequacy, as measured by Standard & Poor's risk based capital model, is considered supportive of the overall capitalization assessment. The group does retain the flexibility to actively manage its capital position. Due to its status as a friendly society the group exclusively considers policyholder returns within a risk-based framework. We anticipate that capital adequacy will further strengthen over the rating horizon. We also note the flexibility that management retains—and has to some extent already implemented—to protect capital adequacy under stress.

Quality of capital

Quality of capital is a relative strength in the overall assessment of capitalization. The limited reliance on VIF and hybrids to support the headline capital adequacy ratio supports our view.

Other capital considerations

The regulatory surplus for the life business in LVFS was £0.3 billion on Dec. 31, 2010, the same as at year-end 2009.

The life business' regulatory capital resource requirement (CRR) increased to £0.8 billion at year-end 2010 (£0.5 billion in 2009). The change is attributable to the increase in the with-profits insurance capital component (WPICC) to £0.3 billion (from £0.1 billion in 2009). As a result, and despite an increase in capital resources, CRR coverage decreased to 1.4x in 2010 from 1.6x in 2009.

The non-life insurance CRR coverage ratio has improved to 1.9x as of year-end 2010 compared to 1.8x in 2009.

Reserves

As outlined, the group retains significant flexibility to manage its capital position, which strengthens the overall assessment of capitalization. For instance, the group's total adjusted capital position could be higher if the allocation of a notional amount of surplus to policyholders (which could be used to support capital in a stress event) was included in working capital. In addition, LVFS has considerable flexibility relative to other companies that have with-profits business. In particular, there is the potential for LVFS to introduce charges to policyholders for the cost of options and guarantees. There is also the potential for falls in equity markets to have less of an impact on capital, due to the significant buffers over the base levels of guarantees for with-profits business.

Financial Flexibility: Good, Low Levels Of Financial Leverage But Limited By Friendly Society Status

We assess LVFS' financial flexibility as good, given that its current need for capital appears to be modest. Historically, the need for capital has originated from the investment in the non-life business to support both inorganic and organic growth; this business is now increasingly self-supportive. LVFS' financial flexibility is somewhat constrained, however, by its status as a friendly society and limited profile in the capital markets.

The low levels of financial leverage currently ensure that the capacity to access the capital markets is less constrained than otherwise. This access to the capital markets is also supported by prospective improvements in cash generation. Accessing the capital markets to satisfy internal capital needs would bolster capital adequacy but would likely have a notable impact on our assessment of the quality of the capital base.

Ratings Detail (As Of 01-Nov-2011)*	
Operating Companies Covered By This Report	
Liverpool Victoria Insurance Co. Ltd.	
Financial Strength Rating	
Local Currency	BBB+/Stable/--
Highway Insurance Co. Ltd.	
Financial Strength Rating	
Local Currency	BBB+/Stable/--
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.