Scottish Widows PLC

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Table Of Contents

Rationale
Outlook
Base-Case Scenario
Company Description
Business Risk Profile
Financial Risk Profile
Other Assessments
Related Criteria And Research
Scottish Widows PLC

**Rationale**

**Business Risk Profile: Strong**

- The group is a principal player in pensions, individual protection, and savings.
- SWplc maintains a strong competitive position in its core life insurance market in the U.K., which we view as a low risk environment.
- Industry wide challenges, such as recent domestic regulatory and political changes, continue to put pressure on margins, which remain below historical highs.

**Financial Risk Profile: Strong**

- We now assess capital and earnings as strong, instead of very strong previously, owing to dividend payouts and reduction in loss-absorbing hybrid instruments. Nevertheless, we believe SWplc has a disciplined and prudent approach to capital management.
- Our assessment of SWplc's risk position as intermediate reflects our view that balance sheet volatility is in line with peers in the U.K. market.
- Financial flexibility is adequate with financial leverage expected to remain below 30% and fixed charge coverage at 6x-8x.
Other Factors

- Our overall assessment of SWplc's credit strengths leads to an anchor of 'a' or 'a-'. We choose the higher anchor because we believe SWplc's capital management is strengthened by a robust risk management framework that more than offsets margin pressures in the current competitive landscape and economic environment.
- We consider SWplc to be strategically important to the Lloyds Banking Group (LBG). We think it unlikely that SWplc will be sold and believe LBG's management continues to support the insurance operations. Although sales through the bank have declined in recent years, we believe the distribution strategy is becoming more focused on leveraging group synergies. That said, there is little track record of successful integration of sales.
- SWplc's 'a' SACP receives no uplift from its strategic importance to its ultimate parent. We rate SWplc at the same level as LBG's group credit profile (GCP) because SWplc's SACP is not lower than the GCP.
- We consider enterprise risk management to be strong, reflecting the robust nature of SWplc's risk management culture, controls, and strategic risk management.
- We regard management and governance as satisfactory. This reflects our assessment of the comprehensiveness of SWplc's financial standards, and management's breadth of experience and expertise.

Outlook: Stable

The stable outlook reflects that on LBG and our expectation that SWplc will maintain its financial profile through controlled asset risk tolerances, and its business profile through defendable market positions in its chosen product areas.

Downside scenario

If we revised down LBG's GCP, we would likely lower the ratings on SWplc. We could also lower the ratings on SWplc by one notch if we consider that:

- Shareholder distribution risks could increase directly as a result of Solvency II regulations, or otherwise, such that capital and earnings weaken to below strong.
- Further debt issuance or earnings weakness were likely to reduce fixed-charge coverage to below 4x.
- The underlying risks in the illiquid loan portfolio were likely to deviate from our current low risk assumptions.

Upside scenario

We currently consider an upgrade unlikely, both at the parent and SWplc level.

Base-Case Scenario
Macroeconomic Assumptions

- We expect the U.K.'s real GDP growth will remain relatively stable at 2.6% in 2015 and 2.7% and 2.5% in 2016 and 2017, respectively. Where GDP growth is accompanied by confidence in the capital markets and among consumers, we expect this will help support SWplc's volumes and earnings. In addition, where GDP growth is bolstered by salary growth this will help grow contributions to SWplc's pension business. Increased lending may also improve protection sales.
- We expect 10-year gilt yields over 2015, 2016, and 2017 will average 2.0%, 2.5%, and 3.0%.

Company-Specific Assumptions

- The contribution from bulk annuity deals will lift up the PVNBp starting 2015. We forecast that margins will remain below 2% in the next two years, but improve to over 2% as the group delivers profitable growth in risk products. The fall in volume of individual annuities will continue to impact new business margins but will be offset by increased protection sales. Overall, the proportion of the lower margin pension business is still expected to increase over the ratings horizon.
- Capital adequacy is expected to be maintained at strong levels from 2015 despite external hybrids being replaced by internal hybrids with lower equity content.
- We expect dividends to be funded out of earnings generation and not to dilute capital adequacy below the 'AA' level, under our criteria.
- We project that profit before tax will increase through to 2017, starting at around £400 million-£500 million in 2015.
- In 2014, there were further acquisitions of illiquid assets and we expect SWplc to increase the proportion of these assets backing its annuity portfolio. To fund this, the group will sell down holdings in gilts and corporate bonds. We expect this would not materially deteriorate the average credit quality of the portfolio.
- Financial leverage will remain below 30% and fixed charge coverage above 6x in 2015 after the replacement of external hybrids, and will increase gradually thereafter.

Key Metrics

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</thead>
<tbody>
<tr>
<td>IFRS net income (mil. £)</td>
<td>400-500</td>
<td>400-500</td>
<td>552</td>
<td>681</td>
<td>(368)</td>
</tr>
<tr>
<td>Present value of new business premiums</td>
<td>&gt;9500</td>
<td>&gt;9500</td>
<td>8,601</td>
<td>9,934</td>
<td>10,005</td>
</tr>
<tr>
<td>Life new business margin</td>
<td>&gt;2%</td>
<td>&gt;1.7%</td>
<td>1.20%</td>
<td>2.60%</td>
<td>3.20%</td>
</tr>
<tr>
<td>S&amp;P capital adequacy</td>
<td>Very strong</td>
<td>Very strong</td>
<td>Extremely strong</td>
<td>Extremely strong</td>
<td>Extremely strong</td>
</tr>
<tr>
<td>Financial leverage</td>
<td>&lt;30%</td>
<td>&lt;30%</td>
<td>25%</td>
<td>25%</td>
<td>N.M.</td>
</tr>
<tr>
<td>Fixed charge coverage</td>
<td>&gt;6x</td>
<td>&gt;6x</td>
<td>6.2</td>
<td>9</td>
<td>N.M.</td>
</tr>
</tbody>
</table>

N.M.--Not meaningful. f--Forecast.

Company Description

SWplc and its core operating entity, Clerical Medical Investment Group Ltd. are strategically important subsidiaries of
the Lloyds Banking Group. Operating in the U.K. life insurance market, SWplc was by sales the top player in corporate pensions in 2014, no. 5 in at-retirement products, and no. 6 in individual protection.

At year-end 2014, SWplc had total assets of £142 billion, with gross premiums written of £6.3 billion and present value of new business premiums of £8.6 billion.

Scottish Widows proposes to simplify the business of the Scottish Widows group of companies. Under the proposal, the assets and liabilities of seven of the group's insurance entities will be transferred into CMIG, its core operating entity. The effective date for the scheme is Dec. 31, 2015. At this date, CMIG is expected to be renamed Scottish Widows Ltd., and will be the only life insurance operating entity in the group.

**Business Risk Profile: Strong**

**Insurance industry and country risk: Low risk for the U.K. life market**

SWplc operates wholly in the U.K. life market.

We assess the U.K.'s overall insurance industry and country risk as low. Our view is supported by our positive opinion of the U.K.'s 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.

**Competitive position: Benefits from a broad product profile**

SWplc's strong competitive position benefits from a well-recognized and respected brand combined with a broad product range. Its position in its core product segments remains unfettered despite falling year-on-year new business premiums written and margins. The group is addressing this trend as part of its strategic initiatives, which include exploring new products and distribution strategies.

<table>
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<tr>
<th>Table 2</th>
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</table>
| **Scottish Widows PLC Competitive Position**

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(Mil. € )</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross premiums written</td>
<td>6,325</td>
<td>7,005</td>
<td>6,705</td>
<td>5,413</td>
<td>4,016</td>
</tr>
<tr>
<td>Change in gross premiums written (%)</td>
<td>(9.7)</td>
<td>5</td>
<td>24</td>
<td>35</td>
<td>9</td>
</tr>
<tr>
<td>Present value of new business premiums</td>
<td>8,601</td>
<td>9,934</td>
<td>10,005</td>
<td>10,219</td>
<td>10,316</td>
</tr>
<tr>
<td>Total assets under management</td>
<td>120,130</td>
<td>122,898</td>
<td>114,345</td>
<td>112,582</td>
<td>60,676</td>
</tr>
</tbody>
</table>

The present value of new business premium margins in 2014 was 1.2%, which was lower than 2013 (2.6%), and the lowest reported margin in five years. This, coupled with lower new business volume, reflects increasing challenges to improve operating performance, with a business model significantly impacted by recent regulatory and legislative changes. We expect volumes to be sustained by increments on existing products, with a lower contribution than prior years coming from sales of new auto-enrolment schemes. Overall, we believe further declines in the absolute value of new business written, as well as new business margins, may occur. We expect new business margins will recover slightly to a minimum of 1.7% in 2015, and above 2% thereafter.
Protection volumes and margins may also benefit from more buoyant lending markets and execution of the group's distribution strategy to forge greater cooperation with the bank to attract wealthier customers.

Similar access to commercial banking clients will aid with improvement in both volumes and margins as the group executes its bulk annuity strategy. We expect the inflow of external bulk annuities as planned will contribute to present value of new business premiums. The potential market for these products is high, and the growth rate is sustainable even as more players enter. To this effect, SWplc would benefit from relationships with the banking group to harness new business opportunities.

Also, the investment strategy for annuities continues to build on its allocation to illiquid assets, for example social housing loans, which in 2014 increased to £1.7 billion, 90% more than the 2013 market value. We foresee further investments in such assets as supporting profitability.

**Financial Risk Profile: Strong**

**Capital and earnings: Strong and likely to remain so**

We have revised our assessment of capital and earnings to strong from very strong. This reflects weaker capital levels stemming from dividend payouts, the replacement of loss-absorbing hybrid instruments with debt issues of weaker quality, and growth in illiquid assets. According to our Standard & Poor's risk-adjusted capital model, we view SWplc's capital as being in the 'AA' range from 2015 and remaining so over our rating horizon.

In common with many U.K. life peers, we see higher proportions of total adjusted capital composed of softer items, such as the credit we give for future profits or hybrid equity, which weighs on our assessment.

**Table 3**

<table>
<thead>
<tr>
<th>Scottish Widows PLC Capital</th>
<th>Year ended Dec. 31</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Mil. £)</td>
<td>2014</td>
</tr>
<tr>
<td>Total shareholder's equity</td>
<td>5,475</td>
</tr>
<tr>
<td>Value of in-force business*</td>
<td>4,864</td>
</tr>
<tr>
<td>Deferred acquisition costs</td>
<td>1,437</td>
</tr>
<tr>
<td>Solvency I regulatory surplus</td>
<td>2,608</td>
</tr>
<tr>
<td>IFRS CMIG German litigation provision</td>
<td>517</td>
</tr>
</tbody>
</table>

*As reported in LBG accounts. Including OEICs and international business.

We expect SWplc to generate profit before tax of around £400 million–£500 million in 2015, and to increase thereafter. However, we anticipate dividend pay-outs will be sensitive to SWplc's risk appetite and its own capital needs. As such, where capital requirements grow faster than presently anticipated, we expect the dividend will be reduced to fund this.

The risk of greater-than-expected growth in capital requirements might arise from sales of bulk annuities exceeding expectations, or from further provisioning relating to the litigation around German legacy policies sold by CMIG.
Table 4

Scottish Widows PLC Earnings

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS net income</td>
<td>552</td>
<td>681</td>
<td>(368)</td>
<td>282</td>
<td>249</td>
</tr>
<tr>
<td>EBIT*</td>
<td>866</td>
<td>781</td>
<td>371</td>
<td>510</td>
<td>386</td>
</tr>
<tr>
<td>EBITDA*</td>
<td>896</td>
<td>807</td>
<td>403</td>
<td>535</td>
<td>409</td>
</tr>
<tr>
<td>Return on shareholder's equity</td>
<td>8.9</td>
<td>10.7</td>
<td>(6.1)</td>
<td>5.7</td>
<td>7.0</td>
</tr>
<tr>
<td>Return on assets (%)</td>
<td>0.7</td>
<td>0.6</td>
<td>0.3</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>New business margin (%)</td>
<td>1.2</td>
<td>2.6</td>
<td>3.2</td>
<td>4.1</td>
<td>3.7</td>
</tr>
</tbody>
</table>

*As defined by Standard & Poor's.

At this stage, we do not expect immediate dividends resulting from the planned restructuring of operating entities. The proposed effective date for the scheme is Dec. 31, 2015. Also, the release of capital associated with this is anticipated to be not sufficiently material to change our dividend assumptions.

In our assessment of total adjusted capital, we deduct the provision (under the U.K. Individual Capital Assessment [ICA] regime) over and above that held on an IFRS basis in respect of the German litigation. We believe the capital held in respect of this provision is not a permanent component of SWplc's capital structure. If the provision is used, the provision will gradually fall as it is paid in compensation to policyholders. Where the provision is not drawn down we believe the capital will be up-streamed as dividends to the ultimate parent.

Risk position: Intermediate, with a well-diversified portfolio offset by high pension benefits exposures

In our view, SWplc has an intermediate risk position.

We understand that the company's investment portfolio is broadly diversified across sectors and obligors. We believe the equity and property holdings held in the with-profit funds are a source of volatility, but recognize that the group has taken actions to reduce shareholder exposure to these in line within its financial management practice. The company's appetite for foreign currency exposure is limited, and exchange rate risks associated with investments are minimal. SWplc invests in U.S. dollar corporate bonds, but these are hedged back to sterling.

SWplc is exposed to a large defined-benefit pension scheme with £1.2 billion of liabilities. We consider this high as a proportion of total adjusted capital. Furthermore, we note that the scheme exhibits modest volatility and has a small, but consistent, surplus on an IFRS basis.

Financial flexibility: Adequate, with a good capital raising track record for the group

SWplc has adequate financial flexibility, in our view. We consider the group's capital needs to be low at present given its capital position. We believe the primary source of financial flexibility will be SWplc's earnings. In our opinion, the group's capital needs are low at present and would depend on significance of changes in the future product strategy.

The two external hybrid debts callable in 2015 were redeemed accordingly, but were not replaced by external market instruments. As at year-end 2014, we believe financial leverage stood at 25% and fixed charge coverage was 6.2x. Our expectation is that financial leverage will be maintained below 30% over the rating horizon and that fixed charge coverage will be about 6x-8x.
Table 5

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial leverage (%)</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Fixed charge coverage (x)</td>
<td>6.2</td>
<td>9.0</td>
</tr>
<tr>
<td>Intangibles to shareholder's equity (%)</td>
<td>48</td>
<td>37</td>
</tr>
</tbody>
</table>

Other Assessments

Enterprise Risk Management: Strong, and linked to efficient capital management

We consider enterprise risk management to be strong for SWplc. This is based on our view that the group has a strong risk management culture, risk controls, and strategic risk management capabilities.

Overall, we consider ERM to be of low importance. This is based on our view that SWplc is predominantly a U.K.-based player, the with-profit fund is a relatively small component of overall liabilities, and the investment strategy at this stage is relatively low risk. Features that could change our view overall might arise from major breaches of the group risk appetite; material growth in the bulk annuity market; or increases in illiquid assets beyond our current expectations.

Management and Governance: Neutral to the rating

We consider management and governance to be satisfactory. This reflects our assessment of the depth and breadth of the management team. We do not expect a material change in strategy following the appointment of a new CEO, an internal candidate from the banking parent. Furthermore, we view the comprehensiveness of financial standards to be a key strength to the assessment. We also believe the board is independent and has been active in challenging dividends paid to the ultimate parent and ensuring they are within its risk appetite.

We believe key challenges for the management team will reside in it demonstrating its operational effectiveness in terms of its ability to improve sales volumes and margins from LBG's customer base, as well as negotiating the impact of material regulatory changes ahead of Solvency II. This may involve recalibrating the investment strategy specific to annuity business, and successfully executing its entry into bulk annuities.

Liquidity: Exceptional, supported by nature of liability profile

We consider liquidity to be exceptional at SWplc. The company is reducing the liquidity of the assets backing the annuity portfolio with a view to increase yield. Since these liabilities cannot be surrendered, this reallocation has not changed our assessment.

There are no significant external debt maturities following the 2015 hybrid calls.
Related Criteria And Research

Related Criteria

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

Related Research

• Research Update: Scottish Widows 'A' Ratings Affirmed Despite Lower Capital Adequacy; Outlook Stable, Aug 5, 2015
Proposed Reforms Are Unlikely To Rock The U.K. Life Insurance Sector, March 25, 2015

Ratings Detail (As Of October 30, 2015)

Operating Company Covered By This Report
Scottish Widows PLC

Financial Strength Rating
Local Currency A/Stable/--

Counterparty Credit Rating
Local Currency A/Stable/--

Junior Subordinated BBB+

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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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