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Solvency data shows L&G lagging, but analysts preach caution

By Lorenzo Spoerry

U.K. insurers with big exposure to annuities, most notably Legal & General Group Plc, would see their solvency ratios shrink dramatically if so-called transitional measures were removed, new data reveals. But insurance industry analysts cautioned against reading too much into the declines given that regulators appear sanguine about the situation.

The figures are revealed in new Solvency and Financial Condition Reports, which are required under the EU's new Solvency II regime and set out a company's capital strength under the framework as it exists now, but also as it would be once the rules are fully implemented. Solvency II mandates that insurers hold capital sufficient to guard against a "1-in-200-year" loss event, including a risk margin that estimates how much compensation another company would require to buy the insurer out if it ran into trouble.

A 100% ratio indicates that an insurer has exactly the level of capital required for such an event, and significant buffers over this are required to ensure ongoing viability and to keep regulators happy.

The full Solvency II regime is only due to come into full force in 2032, with transitional measures in place until then that effectively lower the capital requirements for long-term guaranteed insurance products, principally annuities. L&G's significant exposure to annuities means that if the transitional measures were removed today, its Solvency II ratio would drop to 88% from 163%, meaning it would be 12 percentage points shy of the amount needed to withstand a 1-in-200-year event.

However, the company, which is Britain's second-largest insurer by assets, says this will not affect its ability to grow or pay dividends, as it has more than enough leeway to grow its solvency ratio through organic means.

"Extrapolating forward is a difficult thing to do, but what has been revealed I don't think changes anything either about the fundamentals of the business or the relative attractiveness of what they're doing," Ben Cohen, an insurance analyst with Canaccord Genuity, said in an interview. "Maybe they would look at this and they will weigh how they will look to grow the different parts [of the business], maybe do [fewer annuity] buy-outs and concentrate more on other areas."

Big annuity appetite

Solvency ratios for top 4 UK insurers for 2016
Ranked by total assets

Company	Total assets (£B)	Solvency ratio (%): Regulatory basis*	Solvency ratio (%): Without impact of transitional measures
Prudential Plc	470.50	171	154
Legal & General Group Plc	467.85	163	88
Aviva Plc	440.42	173	139
Standard Life Plc	190.50	177	141

● Life & health ● Multiline

Data compiled May 22, 2017.
* This ratio is calculated based on regular Solvency II norms under European Union regime.
Sources: S&P Global Market Intelligence and SFCR annual reports.

Legal & General reported a full-year 2016 profit of £1.26 billion, up from £1.08 billion in 2015, as gross written premiums grew to £10.33 billion from £6.32 billion. Its total annuity assets rose sharply, to £54.4 billion in 2016 from £43.4 billion in 2015.

Very large companies around the world — including pension funds — have sought to remove liabilities from their books by paying insurers to take them on. Legal & General was very active in 2016 in accepting such risks, including a £1.1 billion buyout from the Rolls-Royce Group in which it guaranteed the retirement benefits of over 11,000 current and former employees. Earlier the same year, it acquired a £3 billion annuity portfolio from AEGON NV, cutting its Solvency II capital surplus by about £50 million.

The figures revealed in the solvency report mean that Legal & General might have to pull away from big annuity buyout deals in the future, Cohen said, despite its appetite for them.

But Barclays insurance analyst Alan Devlin said in an interview that the U.K. Prudential Regulation Authority's decision to allow Legal & General to up its year-end 2016 dividend by 7% — at which time both L&G and the PRA knew what Legal & General's eventual Solvency II ratio would be — is "proof" that the regulator is comfortable with the firm's capital strength.

"The PRA has been very vocal on their support on both the transitional measures and matching adjustment" — which allows insurers to tweak the discount rate used to value long-term assets that are matched against long-term liabilities — Devlin and Angel Kansagra, another Barclays analyst, wrote in a note. "The PRA was well aware of the capital levels when they let the companies increase the dividends at the full year, and let Aviva announce the potential of a £800 million capital return. The PRA is the final arbiter of capital levels (and whether companies comply with the matching adjustment criteria), so if they are comfortable, investors should be comfortable."

Other U.K. insurers with a smaller appetite for annuities business reported a smaller impact from the removal of transitionals. Prudential Plc, which said in 2016 that it had little further appetite for the annuity market, said its Solvency II ratio dips to 154% from 171% once transitional measures are excluded, while Aviva Plc's drops to 139% from 173% and Standard Life Plc's to 141% from 177%.

"The impact of the transitional for Legal & General is bigger than other insurers because annuities are a bigger proportion of its business," Gordon Aitken, an analyst with RBC Capital Markets, wrote in a note. "We however do not believe it is appropriate to look at the position after deducting the transitionals for the simple reason that the regulator does not do this."

Lost in translation

Some continental European insurers have yet to reveal their group-level Solvency II ratios, ex-transitional measures, but analysts covering several such companies told S&P Global Market Intelligence that the impact is likely to be negligible because of their limited exposure to annuities and because their Solvency II ratios are well above the regulatory minimum.

Although Solvency II was meant to standardize insurance regulation in Europe and make cross-border comparison easier, national-level enforcement has meant that each participating country has considerable leeway to interpret the rules as it sees fit. The opacity with which the Solvency II ratio is worked out — with insurers determining the riskiness of certain assets by their own accord — adds to its complexity, experts say.

Despite the obstacles that it raises for British insurers like Legal & General, few in the industry expect the U.K. to adopt a new regulatory regime after it leaves the EU in March 2019. Rejecting EU rules could make it difficult for the U.K. to sell insurance products to individuals and companies on the continent, and the Association of British Insurers, a lobby group, argues that the regime should be transposed directly into British law to ensure continued access to EU markets.

Husain Rupawala contributed to this article.

Article amended at 4:51 p.m. London time May 25, 2017, to adjust a reference to continental European insurers.