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Research Update:

South African Life Insurer Old Mutual Life Assurance Co. Assigned 'zaAAA/zaA-1' South Africa National Scale Ratings

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Overview

- Old Mutual Life Assurance Co. (South Africa) Ltd. (OMLACSA) is the leading life insurance company in the South African market. It offers a diversified range of products and has widespread distribution channels.
- It is also the largest life operation within Old Mutual Emerging Markets (OMEM), one of the four business segments of the Old Mutual Group (OM PLC), a diversified financial services group.
- OMLACSA has a resilient balance sheet thanks to its prudent capital and reserve buffer policies and its product and liability structures, the vast majority of which allow flexible guarantees and include mechanisms to share profit and loss with policyholders.
- We are assigning our 'zaAAA/zaA-1' long-term and short-term national scale ratings to OMLACSA.
- We do not expect OMLACSA and its parent OMEM to suffer material negative development on their businesses or balance sheets as a result of the planned separation of OM PLC into four separate segments.

Rating Action

On April 26, 2016, Standard & Poor's Ratings Services assigned its 'zaAAA' long-term and its 'zaA-1' short-term South Africa national scale counterparty credit ratings to Old Mutual Life Assurance Co. (South Africa) Ltd. (OMLACSA). At the same time, we assigned our long-term 'zaAA+' South Africa national scale issue ratings to the 10 subordinated and deferrable notes issued under OMLACSA's South African rand (ZAR) 10 billion medium-term notes (MTN) program.

Rationale

The ratings reflect OMLACSA's strong positioning in the South African life insurance market, as demonstrated by its leading positions in diversified product segments and its diversified sales forces. Other credit strengths include OMLACSA's resilient balance sheet, resulting from prudent capital and reserve buffer policies. On the downside, we take into account the difficult operating environment in the South African life insurance industry. Exposure to the South African economy weighs on the market and credit risk of OMLACSA's assets.

The OMEM group has additional credit strengths and weaknesses relative to OMLACSA, in our view. Among the strengths, we see further business

diversification through Mutual & Federal, the property/casualty (P/C) arm, the Old Mutual Investment Group (OMIG) adding asset management capabilities, and small, but growing activities outside South Africa.

Our rating is based on our consolidated view of OMEM, even though OMEM is largely influenced by OMLACSA, which represents more than 90% of OMEM's assets and liabilities. We consequently consider OMLACSA as a core operating company of OMEM. OM PLC has announced that it will separate into four separate segments by the end of 2018. We have considered the influence of the larger OM PLC group, but our base-case assumption is that the separation would have a limited impact on our view of OMLACSA's creditworthiness.

Our insurance industry and country risk assessment (IICRA) for the South African life insurance market is moderate mostly due to the country's dampened economic prospects, which are likely weigh on real growth in the life sector and lead to more intense competition within the market. This compares unfavorably with most of the life insurance markets we assess, where the IICRA is intermediate and neutral to the ratings. As such, the IICRA is a relative weakness for the rating. OMEM's exposure outside South Africa represents less than 10% of its liabilities and 20% of new business volumes.

Our view of OMEM's competitive position is largely based on OMLACSA's strong competitive position in South Africa. OMLACSA provides fully fledged life, savings, and wealth management solutions and holds leading positions in the retail and corporate segments. In the retail market, OMLACSA is leading the traditional players in the low-income segment, and it holds top-three positions in most of the middle-income segments. OMLACSA is a top-three player in the high-net-worth business, and is the market leader in the corporate segment.

OMLACSA draws its strength from its large product offering in both the with-profit segment, where it leads the market, and in unit-linked offers. Diversified distribution abilities through majority-controlled networks add to OMLACSA's competitive strengths. Distribution channels include employee sales, tied agents, agency franchise distribution, and personal finance advice (PFA). Mutual & Federal's No. 2 position in the P/C market complements OMEM's dominant position and product offering in South Africa.

OMEM's positions outside South Africa are small and fragmented, and much less profitable than OMLACSA. Still, they sow the seeds for future diversification. OMEM has leading positions in small markets such as Zimbabwe, Malawi, and Namibia and second-tier positions in Kenya, as well as a presence in Nigeria. Overall, we expect OMEM to post sound operating profit measures over the coming two years, with return on equity (ROE) of above 20% and value of new business margins of above 3%, in line with its closest South African peers.

Our view of OMEM's balance-sheet resilience is mostly supported by the substantial buffers existing within OMLACSA's with-profit policyholder funds (WPF). Such buffers, in particular the bonus-smoothing reserves and the nonvested part of the bonuses, could offset the potentially high volatility

due to substantial investment in equities within the WPF (60% to 70% of invested assets). Smoothed-bonus reserves make up half of OMLACSA's reserves, while unit-linked funds, mostly without investment guarantees, make up 40% of reserves.

This liability profile, which includes significant mechanisms for sharing profit and loss with policyholders, contributes to our view of the balance sheet's resilience to investment market volatility. In addition, most products pay market value on termination. That said, the highly competitive nature of the saving market and high policyholder expectations might discourage OMEM from making full use of the loss-sharing mechanisms in case of stress. We therefore view OMEM's consolidated capital adequacy as upper adequate.

Prospectively, our base-case assumption is that OMEM's dividends to parent OM PLC are likely to be a drag on capital adequacy, in light of OMEM's expected growth. In addition, OMEM has identified a budget for acquisitions that it could use in the next three years. Therefore, we expect capital adequacy, as we calculate the measure, to decline over the next three years, but to remain commensurate with an upper adequate assessment. In using our capital adequacy model criteria listed below, we have applied a criteria interpretation that allows us to assume the duration mismatch assumption for South African life insurers is two years.

We view the risk position as intermediate, that is, neutral to the ratings. OMLACSA's substantial asset exposure to high-risk assets, such as equities, properties, loans, and speculative-grade and unrated bonds is mitigated by the profit-and-loss features of its main product lines. The largest sector exposure is banking, and excluding government securities, the other sector and obligor exposure is largely diversified. Our assessment also depends on the credit quality of assets. A deterioration of the average credit quality of bonds to lower than 'BBB' could have a negative impact on our view of OMLACSA's creditworthiness.

We view OMEM's financial flexibility as adequate. Its financial leverage is low and its fixed-charge coverage is healthy, despite the hybrid debt issuances during 2015. We view OMLACSA as self-sufficient for capital generation to fund organic growth, per our base-case assumptions. Consequently, we see its need for external capital as limited. OMEM has determined a budget for external growth and does not rely on its parent to fund acquisitions. On the downside, heavy cash dividend payments to the parent constrain OMEM's ability to increase its capital buffer. We expect the process of splitting up OM PLC to be neutral to OMEM's financial flexibility. Nevertheless, we could reassess our view on financial flexibility as and when we gain a clearer view of OMEM's future shareholder structure.

We assess OMEM's management and governance as satisfactory. OMEM's management has extensive experience and expertise in its chosen markets and risks. It has a clear strategy and adequate structure and skills to be able to execute it. We do not expect the announced dismantling of OM PLC to distract OMEM's management and strategy. OMEM's management stands on its own and relies on

limited input from OM PLC with regards to operational management. With regards to strategy, OM PLC's managed separation phase could lead OMEM to be more inward-looking and to reassess its fragmented positioning outside South Africa. However, we do not expect the separation to lead to a substantial change to OMEM's strategic focus in South Africa or its selective growth abroad.

We view enterprise risk management (ERM) as adequate and ERM as having high importance to the rating, given the substantial market risk in OMEM's assets, and its broad geographic exposures and complex structure. We base our views on the practices in place for OMLACSA that OMEM replicates for its foreign businesses. OMEM has explicit capital-at-risk and earning-at-risk, cash-at-risk, and operational risk tolerances and has adequate processes in place to maintain its risk positions within tolerances, in our view. OMEM has also an extensive key risk identification program where it splits the main risks into different tolerance levels and which it complements with management actions. Risk reporting is extensive and granular. Management and board awareness of risk-taking is high, as demonstrated by extensive risk focus in quarterly board reviews.

Liability bias toward smooth with-profit business and the related heavy exposure to equities support heavy charges under our liquidity analysis compared with insurers that have asset allocations mostly geared toward investment-grade bonds. However, OMEM has exceptional liquidity on aggregate, thanks to the liquid nature of the investments backing its liabilities, and because of its ability to apply market-value adjustments if there is a surge in policy lapses under stressful market conditions. We consider that collateral posting risk is manageable and that risks arising from contingent liabilities are unlikely to materially affect liquidity.

OMLACSA holds approximately 95% of its assets in South Africa. However, the bulk of its life liabilities are with-profit or unit-linked and feature substantial loss-sharing abilities with policyholders. Should a severe default stress occur--such as our hypothetical sovereign stress--we expect OMLACSA's policyholder funds to share the bulk of losses. We would expect shareholder funds to suffer substantially under such a scenario, but not be fully exhausted. Therefore, OMLACSA and OMEM withstand our foreign currency sovereign default stress test. However, we do not view OMLACSA as passing the more-severe local currency stress test scenario.

The OM PLC Group already operates as a conglomerate of four separate businesses, OMEM, Nedbank, OM Wealth (OMW), and OM Asset Management (OMAM). There are limited business interactions between these segments, and in that regard we expect the dismantling to be neutral for OMEM's and OMLACSA's business operations.

On the financial side, the most direct impact would be the disposal by OMLACSA of its stake in Nedbank. As part of our analysis, we write down OMLACSA's shares in Nedbank as an affiliate, based on its value in OMLACSA's accounts. The remaining uncertainty is the stake that OM PLC would retain in OMEM at the

end of the dismantling process, and OMEM's shareholder structure (listed, controlled by OM PLC, or by another owner).

In our base case, we assume that OMEM and OMLACSA will not be negatively affected by the separation, due to the independence of their strategy and their board, their expected capital policy, and the stringent regulatory rules in South Africa.

We could lower the ratings on OMLACSA if we took a similar action on our sovereign ratings on South Africa. We could also lower the ratings if we saw exceptional dividends exhausting capital; unexpected negative consequences of OM PLC's dismantling; or earning fundamentals deteriorating, for example, ROE to below 15% or new business margin below 2.5%.

Related Criteria And Research

Related Criteria

- Standard & Poor's National And Regional Scale Mapping Tables, Jan. 19, 2016
- National And Regional Scale Credit Ratings, Sept. 22, 2014
- Group Rating Methodology, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- 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
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments , Feb. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

New Rating

Old Mutual Life Assurance Co. (South Africa) Ltd.	
South Africa National Scale	zaAAA/--/zaA-1
Subordinated	zaAA+

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