Our Transition

From UK Mutual Life Insurer to Global Investment Company

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Contents

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Our Thinking:
Thought Leadership

Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.

Introduction

Over the past 20 or so years, the company has transformed from a traditional UK-focused mutual life insurer, owned by its members, to a successful, publicly listed global investment company, Standard Life Aberdeen.

At Aberdeen Standard Investments, the investment management business of Standard Life Aberdeen, we get many questions from existing and prospective insurance clients around the globe as to how we achieved this transition. In this article, we document our journey.

"We have nearly 200 years' experience of managing our own and third-party insurance assets – probably no other asset manager understands the long-term needs of this sector better."

Insurance industry background - global drivers of change

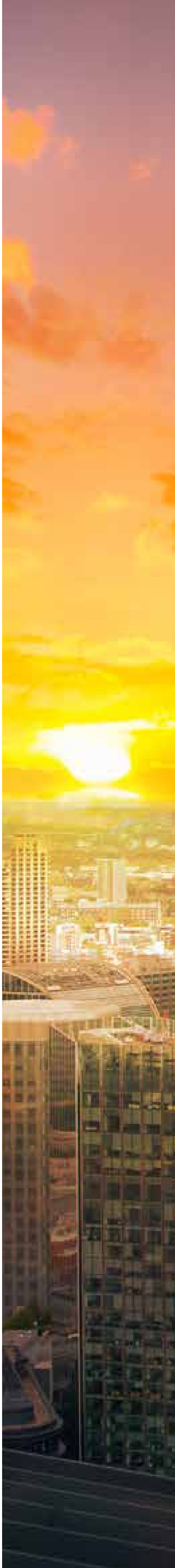
There is a growing awareness among many insurers that their current business models are likely to be unsustainable in the longer term, as a number of factors combine to drive industry change.

- The past 30 years have been characterised by a secular fall in interest rates, which have now reached record low levels.
- Modern risk-sensitive solvency systems in conjunction with market-based asset and liability valuations have crystallised the true costs of the risks, including asset risks, on insurers' balance sheets. This restricts the choice of insurance investment strategy.
- More stringent conduct regulation, designed to protect customers from unfair treatment, high commissions and opaque charging structures, presents additional requirements and opportunities for insurers.

The cumulative effect of these pressures and constraints has led insurers to consider alternative business models, typically characterised by the following features.

- Savings propositions are capital-light and outcome-based. This means customers take more responsibility for managing their individual financial risks, supported by innovations such as risk-based fund ranges. Our MyFolio range is an example of this.
- The investment solution is increasingly outcome-based and a key differentiator. Specialist investment management skills are often needed to compete successfully.
- Charging structures are transparent, so the customer knows the costs of the proposition and any advice received. Propositions are sold via professional, fee-based advisers.

These drivers of change, and our response, are behind the company's business model transition story.



Our Life Company history in brief

Formed in 1825 and converting to a mutual insurer in 1925, we have a long track record of growth, diversification, business flexibility and innovation. By the 1990s, we operated in a number of international markets. The firm was Europe's biggest mutual insurer and one of the strongest global life insurers.

Our core business offering previously consisted of traditional capital-heavy, guaranteed life insurance savings products, backed by high equity allocations. These products were sold by independent advisers, who were remunerated using commission funded by the customer through the product's charging structure.

As long as equity markets performed well and generated high returns over long periods, this business model provided outstanding investment returns for customers, rewarded independent advisers and generated enough retained profits to keep the business growing rapidly.

However, we recognised the risks inherent in this business model. In the mid-1990s, the firm decided to diversify away from the core UK life insurance business into other UK financial services markets and geographies.

This built on an earlier push into mutual funds, and progress already made in switching away from guaranteed savings and investment products in favour of more capital-light investment-linked offerings.

Diversification demanded a first-class investment management operation. It led to the formation of a dedicated investment manager, Standard Life Investments (name chosen to reflect the brand and heritage of the Life Company parent).

As part of its effort to diversify geographically, the firm also developed a joint venture life insurance and investment management businesses in conjunction with Indian mortgage finance firm, Housing Development Financing Company (HDFC).

These latter two steps have proved particularly rewarding and lucrative.

Examples of product literature from the 1930s
Image reproduced courtesy of Standard Life Aberdeen Archive

The creation of our asset management business

Our stand-alone asset management arm was created in 1998, the original rationale being to help the firm attract third-party assets for management. It was felt that, realistically, this could not be achieved by the investment department of a mutual life insurer with limited external investment credentials.

At the time, the asset management capability within our insurance firm was considered to be inferior to that of dedicated investment management companies. Our success in the field of asset management helped to dispel the generality of this perception.

Prior to that, our investment capabilities lay solely in the insurance firm's investment department. It mainly comprised equity, fixed income and property functions, which supported the insurance firm's core traditional guarantee savings, annuity and investment-linked products.

In order to attract – and retain – third-party assets, broader asset capability had to be created and solid performance track records established.

Achieving these ambitious goals required substantial investment over a sustained period.

The development of a world-class asset manager was crucial not only for attracting third-party assets for management but also in providing innovative investment solutions. This allowed us to offer effective, transparent, capital-light, outcome-based propositions, equipping the business to compete with wealth and specialist asset managers.

Several factors contributed to this success. In particular, the company was given full autonomy to develop a new investment firm and new investment brand, able to attract and retain global third-party assets, rather than being a manager of captive insurance assets. This was vital to attract and retain talent, establish a distinct investment culture and provide world-class investment solutions.

Insurance risk-based capital and market valuation in the UK

Risk-sensitive solvency and valuation regimes – such as Europe's Solvency II and its numerous variants, including the International Association of Insurance Supervisor's Insurance Capital Standard – are rapidly being adopted by insurers around the globe.

In the early 2000s, the UK's Financial Services Authority (FSA) was an early adopter of Solvency II-type ideas and thinking. As well as its realistic balance sheet valuation approach, the FSA's individual capital adequacy standards (ICAS) regime introduced genuine risk-sensitive solvency into insurance markets.

These initiatives were triggered by specific problems in the UK market, in particular, the collapse of mutual insurer Equitable Life. Their purpose was to improve insurance risk management and provide more meaningful and risk-appropriate measures of insurer solvency and financial strength.

Our Life Company realised it must strengthen its balance sheet. To do this, it gave up its much-prized mutual status and raised £1 billion of new equity capital. It used this to bolster its financial strength and begin the business and product model transition we describe here.

During this time, we became even more intently focused on the rigorous management of risk and capital. For example, the company started avoiding unrewarded market risk in guaranteed savings products, unless such risks could be substantially reinsured or hedged off-balance sheet to third-party risk-takers.

Product model transition also began in earnest. Traditional capital-heavy, long-term guaranteed savings and annuity products were gradually displaced by more transparent capital-light, outcome-based propositions. In these new offerings, innovative investment solutions and componentry, sold via highly professional, fee-based distribution models, provided the added value.

Interestingly, we are seeing the new proposed fair value accounting standard IFRS17 drive similar pressure for change in certain Asian insurance markets. In these regions, implementation of this standard is more imminent than upgrading of risk-based solvency regimes. However, the business outcome is likely to be the same, as insurance markets seem likely to transition to capital-light, outcome-based business models.

Insurance distribution models in the UK

It used to be common practice in the UK that, when an independent adviser introduced a customer to an insurer, they would receive commission from that insurer. The insurer would recoup the commission from the customer via the insurance product's charging structure. The customer was often unaware of this arrangement, sometimes believing the adviser's services to be free.

The Retail Distribution Review (RDR), implemented in the UK from 2012, essentially prohibited the use of traditional commission-based insurance distribution models for insurance savings products. It replaced them with fee-based models (although commission is still allowed for insurance risk products like term assurance).

Under fee-based models, the customer agrees the fee to be paid to the adviser for advice received. Additionally, there is transparency and disclosure for the customer regarding the expected investment returns of an insurance savings product and the associated charges.

As a company, we started introducing non-commission distribution models into the Retail (individual business) and Workplace (group business sold via employers) insurance savings product channels from 2004, well before RDR. These models fitted naturally with the transparent capital-light, outcome-based propositions that our firm was increasingly offering. Moreover, in the company's view, non-commission distribution models were in the best interests of customers.

Outside the UK, commission models are still widely used in most markets. However, fee-based models are beginning to attract interest from regulators in both Europe and Asia and, we expect, will eventually gain a foothold globally – simply because they are better for customers.

Our first computer
We purchased our purchased its first computer in December 1958. Although relatively small for the time, the computer weighed two tons and had to be lifted through a window of the George Street office with a crane.

Image reproduced courtesy of Standard Life Aberdeen Archive.

The insurance product model transition

In the early 2000s, the firm's UK Pensions and Savings business undertook insurance product model transition journeys for both its Retail (individual business) and Workplace (group business sold via employers) channels.

Over this period, sales of traditional, capital- heavy long-term guaranteed savings and annuity products were gradually switched off. In their place are more transparent capital-light, outcome-based and fee-based propositions.

Related insurance innovations include a Self-Invested Personal Pension product and the Wrap adviser platform. The latter allows advisers to access their customers' investments and propositions all in one place. It also makes servicing and reporting management of client accounts much easier and more scalable, benefitting both advisers and clients.

Additionally, ahead of RDR and its restrictions on commission, the MyFolio range of risk-based funds was designed specifically to help advisers and customers understand, manage and control investment risks.

More recent initiatives include the 1825 financial planning business, created to fill a gap in the advice market. This followed the introduction of pensions freedoms in the UK in 2014. With pension savers now facing a huge and confusing range of retirement options, 1825 advice aims to help prevent customers making decisions that might lead to bad outcomes, and which may be irrevocable.

'Capital-heavy' versus 'capital-light'

Capital-heavy insurance products consume large amounts of capital on an insurer's balance sheet. That is, they reduce the amount of surplus capital in excess of their associated solvency, or economic, capital requirement. (This capital is subsequently released when the product matures and leaves the balance sheet.)

Conversely, capital-light products consume relatively little capital. Moreover, under Solvency II, many of the capital-light, outcome-based propositions insurers now offer are actually capital accretive. That is, whenever one of these propositions is written on an insurer's Solvency II balance sheet, it generates capital in excess of its associated solvency, or economic, capital requirement. So, arguably, writing this type of business strengthens the regulatory balance sheet, while also generating asset flows for the insurer's investment manager.

From a client perspective, the capital-light approach effectively removes any guaranteed returns that certain products used to offer. It also shifts investment risk from the insurer to the customer, so that the latter shoulders the everyday 'ups and downs' of markets.

Standard Life Aberdeen today

Chart 1 provides a pictorial representation of Standard Life Aberdeen's transformation story and highlights two more recent milestones that, in particular, helped complete our transition to a capital-light, global investment company.

The first of these was the merger of Standard Life Investments with Aberdeen Asset Management in 2017. The merger combined the strengths and capabilities of each firm, and diversified both companies' revenue exposure in terms of both geography and asset class. It also provided scale, allowing the newly formed publicly listed holding company Standard Life Aberdeen (SLA) to invest for growth, innovate and improve operational efficiency.

The merger also led to the rebranding of the investment managers Standard Life Investments and Aberdeen Asset Management to form Aberdeen Standard Investments (ASI).

The second major milestone was the sale in 2018 of Standard Life Assurance Limited to Standard Life Aberdeen's strategic insurance partner Phoenix Group. As a consequence, Phoenix is now Europe's largest consolidator of European closed-book life insurance companies and a UK market leading writer of capital-light, outcome-based pensions accumulation and decumulation products.

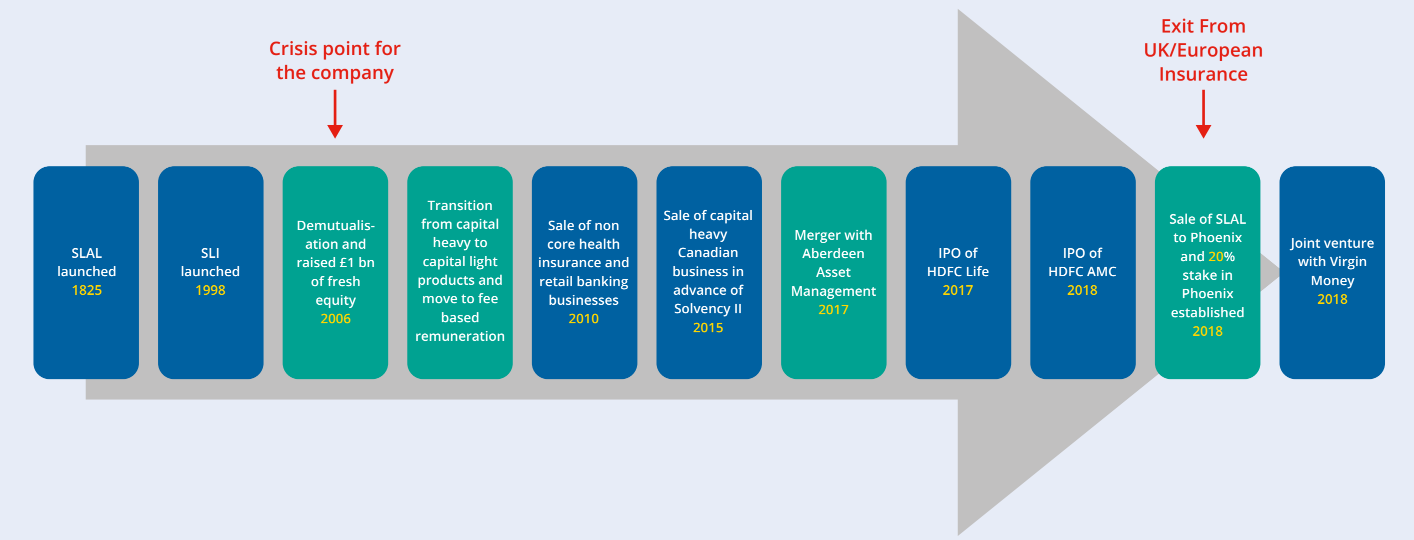
Previously, Aberdeen Standard Investments managed the bulk of Phoenix's assets. Post the sale of Standard Life Assurance Limited, Aberdeen Standard Investments retained management of Standard Life Assurance Limited's assets through an even stronger strategic relationship with Phoenix. As an important part of the deal, Standard Life Aberdeen took a 20% stake in Phoenix, demonstrating commitment to Phoenix and its closed-book consolidation model.

The close strategic relationship with Phoenix has potential to generate even more assets for management for Aberdeen Standard Investments, as Phoenix continues to acquire and grow. It is also facilitating the co-creation of innovative Solvency II efficient insurance solutions – for example, the Private Markets Fund Financing solution developed by Aberdeen Standard Investments from a Phoenix idea.

Standard Life Aberdeen also retained Standard Life Assurance Limited's capital-light platform businesses. This is now housed in the Standard Life platform business, wholly owned by Standard Life Aberdeen.

Notably, the sale of Standard Life Assurance Limited to Phoenix marked Standard Life Aberdeen's exit from UK and European insurance. However, Standard Life Aberdeen still retains its highly lucrative joint venture insurance businesses in India and China.

Chart 1: Standard Life Aberdeen Journey from traditional life insurer to global asset manager



Today, Aberdeen Standard Investments is a global investment manager, with total assets under management of £505 billion worldwide (as at 31 December 2018), including roughly £290 billion of insurance assets, making it a leading manager of insurance assets globally.

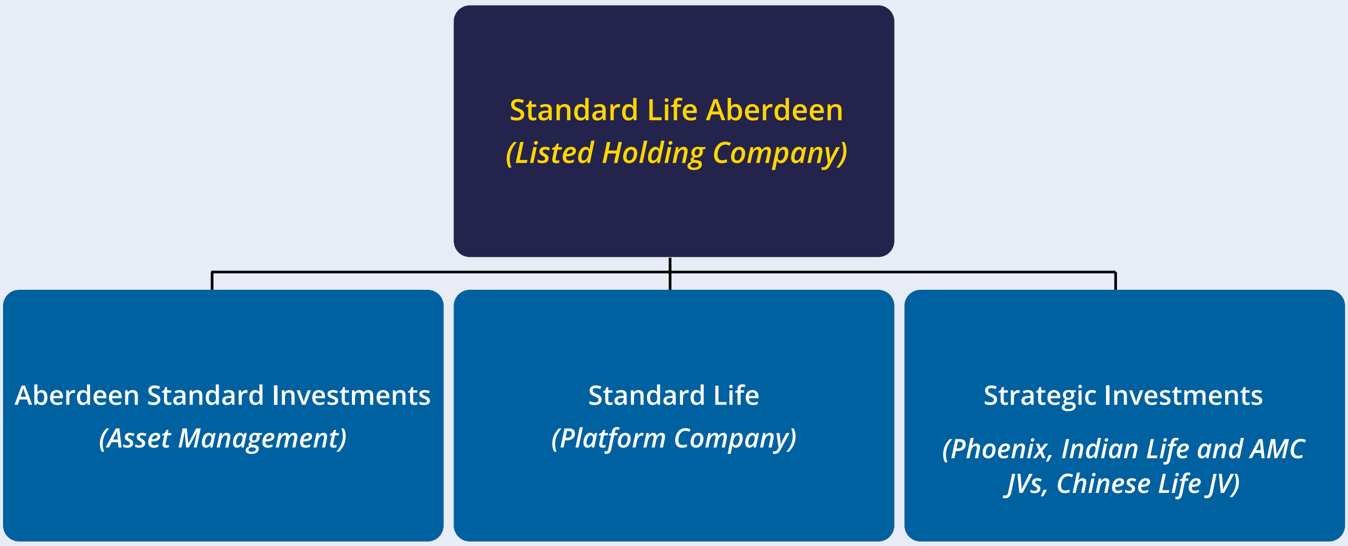
Standard Life, the platform company, provides vital online services to financial advisers through the Wrap, Elevate and Parmenion platforms. These allow advisers to access and manage their clients' investment portfolios efficiently. Additionally, they provide facilities for investments to be selected, bought and sold.

Advisers can also use the platforms to access educational programmes and webcasts, as well as company literature, research and investment insights. We expect that the development of platform businesses will accelerate globally, as insurance markets transition to capital-light, outcome-based and fee-based insurance savings models.

Strategic Investments include the 20% Phoenix stake and joint ventures in India and China. In India, SLA has stakes in HDFC Asset Management and HDFC Life, providing footholds in one of the world's fastest growing markets. The stake in Heng An Standard Life (HASL) in China gives potential access to one of the biggest pools of financial assets globally, and the possibility of playing a significant role as the Chinese pension market develops.

The current high-level corporate structure of Standard Life Aberdeen today is represented in Chart 2.

Chart 2: Standard Life Aberdeen - corporate structure

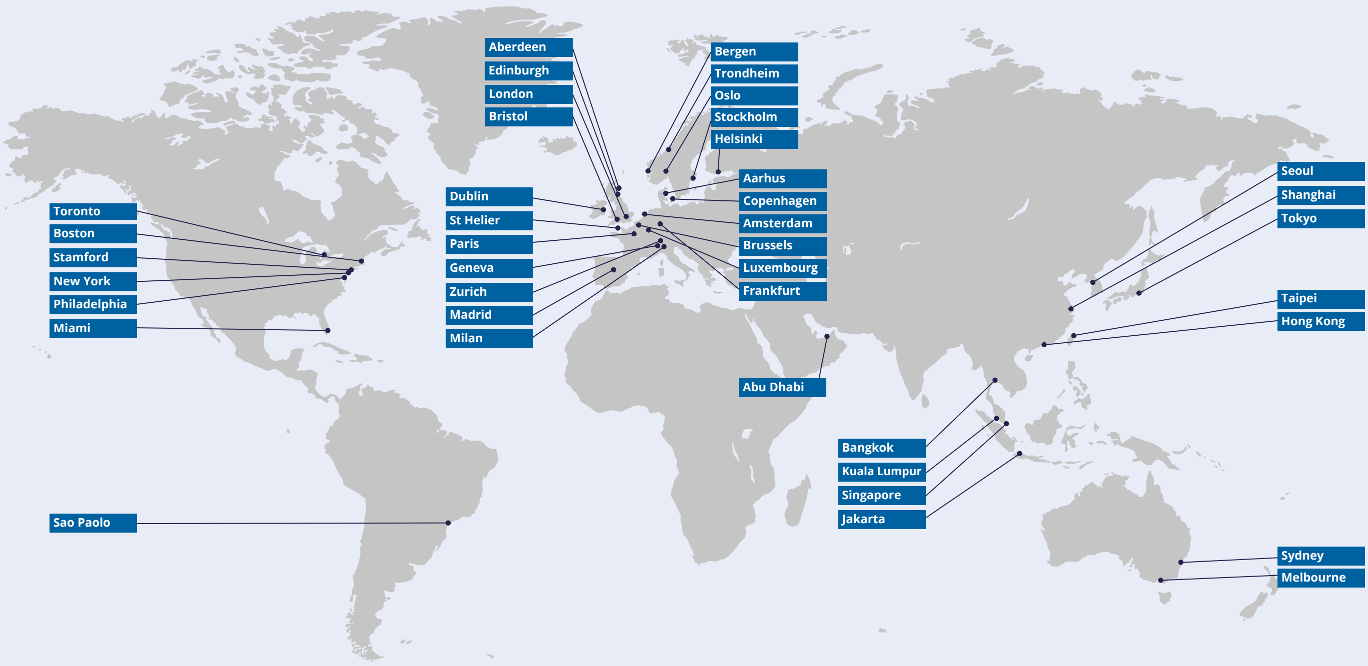


Expanding our global footprint

Standard Life Aberdeen continues to grow through innovation and diversification. Today, the company has operations across the globe (see Chart 3).

Chart 3: Aberdeen Standard Investments - Our Global Reach

A presence in over 40 locations keeps us close to our client-base.
Map correct as at 30 April 2019.



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Investment involves risk. The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results.

Aberdeen Standard Investments is a brand of the investment businesses of Aberdeen Asset Management and Standard Life Investments.

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The author would like to thank Karyn Williamson, Company Archivist, for her help in procuring the images used in this paper.

Who we are

Aberdeen Standard Investments is the largest active manager in the UK and one of the largest in Europe*. It has a significant global presence and the scale and expertise to help clients meet their investment goals. The investment needs of our clients are at the heart of what we do. We offer a comprehensive range of investment solutions, as well as the very highest level of service and support.

***as at 30 Jun 2018**

Our thinking

Visit our website to access our range of thought leadership papers, insights on current events effecting markets, our market and economic forecasts, plus tools to help you make better investment decisions.

Contact us

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