MOODY'S INVESTORS SERVICE

Credit Opinion: Pohjola Insurance Ltd

Global Credit Research - 30 Nov 2015

Helsinki, Finland

Ratings

Category	Moody's Rating
Rating Outlook	STA
Insurance Financial Strength	A3
OP Financial Group	
Rating Outlook	STA
Pohjola Bank plc	
Rating Outlook	STA
Senior Unsecured	Aa3
Senior Unsecured MTN	(P)Aa3
Subordinate	Baa1
Commercial Paper	P-1
LT Issuer Rating	Aa3
LT Bank Deposits	Aa3

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Key Indicators

Pohjola Insurance Ltd[1][2]

	2014	2013	2012	2011	2010
As Reported (Euro Millions)					
Total Assets	3,454	3,205	3,054	2,847	2,820
Total Shareholders' Equity	441	392	372	256	233
Net income (loss) attributable to common shareholders'	228	150	216	23	115
Gross Premiums Written	1,259	1,149	1,033	949	853
Net Premiums Written	1,205	1,093	984	895	814
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	142.7%	163.1%	150.1%	180.9%	170.4%
Reinsurance Recoverable % Shareholders' Equity	16.1%	15.4%	15.7%	23.7%	16.0%
Goodwill & Intangibles % Shareholders' Equity	9.6%	10.6%	10.5%	8.5%	6.0%
Gross Underwriting Leverage	6.6x	6.5x	6.0x	6.6x	5.7x
Return on avg. Capital (1 yr. avg ROC)	35.7%	24.2%	36.8%	4.0%	20.4%
Sharpe Ratio of ROC (5 yr. avg)	181.3%	182.0%	43.5%	NA	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-0.1%	1.8%	0.1%	0.8%	-2.0%
Financial Leverage	9.4%	9.3%	9.3%	9.9%	9.4%
Total Leverage	9.4%	9.3%	9.3%	9.9%	9.4%
Earnings Coverage (1 yr.)	73.8x	50.7x	66.8x	6.8x	45.3x
Cash Flow Coverage (1 yr.)	NA	NA	NA	NA	NA

[1] Information based on IFRS financial statements as of Fiscal YE December 31 [2] Certain items may have been relabeled and/or reclassified for global consistency

Opinion

SUMMARY RATING RATIONALE

Moody's A3 (stable outlook) insurance financial strength rating (IFSR) on Pohjola Insurance Ltd (PIL) reflects Pohjola's strong non-life market position in Finland, as well as its good financial fundamentals with consistent profitability and relatively low, though increased financial leverage. These strengths are off-set by its relative lack of brand reach and geographic diversification, a relatively high proportion of high risk assets in recent years, and a relatively low target Solvency II ratio. The A3 IFSR of PIL, which represents the vast majority of Pohjola's non-life insurance business (PNLI), receives no uplift as a result of its ownership by the Finnish cooperative banking group, OP Financial Group, given the a3 BCA of the banking operation.

The vast majority of PNLI is accounted for by PIL which is a separate legal entity to the other smaller Non-Life operation, A-Insurance Ltd, which provides insurance for commercial truckers and taxi service branches, although all employees are employed by Pohjola. Since it has acquired the minority shares in Pohjola Bank, which currently owns PIL, OP Cooperative intends transferring ownership of the Non-life Insurance directly to itself in the future, and has planned to transfer the Wealth Management segment at the end of 2015. As part of the re-organisation process, starting from 1 January 2015, OP-Pohjola Group has been renamed as OP Financial Group. From April 2016, the Banking, Non-Life insurance and Wealth Management businesses will all come under the OP brand. The new management system is founded on three business segments: Banking, Non-life Insurance and Wealth Management. As part of the reorganization of the banking activities the Group decided to abandon the plan to merge the two banking operations, Pohjola Bank plc and Helsinki OP Bank Ltd. Helsinki OP Bank Ltd will be converted from a limited liability company to a cooperative bank during 2016. At the same time Pohjola Bank plc will be renamed OP Corporate Bank plc. Pohjola Insurance will become OP Insurance from April 2016.

At 9M 2015, PNLI's business, which is almost exclusively conducted in Finland, was split, in terms of net earned premiums, 53% private customers, 43% corporate customers, with the remaining 4% from the Baltic States.

On 15 May 2015, PIL's IFSR was affirmed with a stable outlook. Prior to that in May 2012, the IFSR was downgraded to A3 with a stable outlook assigned, driven primarily by the wider downgrade of the OP Financial Group (please see relevant press release for further details).

Credit Strengths

-Strong market position in Finland

-Very good profitability, with relatively low combined ratio, although reliance on realised gains

-Relatively low, though increased financial leverage

-Importance to OP Financial Group in light of cross-selling opportunities.

Credit Challenges

-At least 90% of premiums come from a single country, namely Finland.

-Relatively high proportion of high risk assets has been a feature of recent years

-Relatively low target Solvency II ratio, with meaningful dividend payments to parent a recent feature

Rating Outlook

The rating outlook is stable.

What to Watch for:

- Potential for market value losses on the investment portfolio due to the relatively higher risk investment portfolio

- Seasonality of losses (particularly in Q1 due to winter related claims)

- Transfer of ownership of PIL to OP Cooperative from Pohjola Bank

- Potential for reserve volatility with PNLI's reserves vulnerable to longevity risk and a lowering of the discount rate

- Profitability and investment portfolio mix trends against the background of very low interest rates and equity market volatility

What Could Change the Rating - Up

In the medium term, positive rating pressure could arise from the following:

-An upgrade of OP Financial's BCA

-A material reduction in high risk assets

-Meaningful geographic and product line diversification without sacrificing profitability

What Could Change the Rating - Down

Negative pressure could arise from:

-A downgrading of OP Financial's BCA

-Material weakening of market position.

-Failure to produce a combined ratio, on a cross-cycle and IFRS basis, of below 95%.

-A weakening of capital adequacy

Notching Considerations

Not applicable.

DETAILED RATING CONSIDERATIONS

Moody's rates PIL A3 for insurance financial strength which is consistent with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard. The scorecard and associated text below are based on Pohjola Insurance Limited on an unconsolidated basis unless otherwise stated.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Market Position, Brand and Distribution: A - LARGE MARKET SHARE BUT CONCENTRATION IN RELATIVELY SMALL MARKET (FINLAND)

With its strong market position in Finland, in which it is currently the largest non-life player with around a 32% market share at YE2014, PNLI's relative market share metric (of which PIL is the vast majority) remains very good. Whilst the OP Financial Group connection helps to enhance its customer base and to consolidate its market position, Moody's believes that a challenge for Pohjola will be to increase its market share meaningfully without compromising profitability. Notwithstanding its strong market position, Pohjola operates almost exclusively in the relatively small Finnish market which means it lacks the franchise strength and brand reach which characterises a number of other European P&C operations including some Nordic peers. Overall, we consider the market position, brand and distribution to be consistent with an A rated company.

Product risk and Diversification: Baa - COMMERCIAL ACCOUNT AND LIABILITY ORIENTATION, AND CONCENTRATION IN FINLAND

With a Commercial account (46%) and Liability orientation (54%), Moody's views the portfolio as potentially more volatile than, for example, some of its Nordic peers. Product diversification is considered good with four distinct lines of business - Motor, Workers Compensation, Accident and Health and Property- producing at least 10% of premium each. However, this is off-set by the concentration in Finland, which itself is highly concentrated, and in three business lines - Statutory Workers' Compensation, Property and Motor which together account for 69% of gross written premiums. Overall, we consider the product focus and diversification to be consistent with a Baa rated company.

Asset Quality: A - HIGH RISK ASSETS SOMEWHAT PRESSURISE ASSET QUALITY

Moody's considers PIL's overall asset quality to be good, albeit high risk assets remain elevated at PIL. At YE 2014, goodwill/intangibles and reinsurance recoverables only represented around 10%/16%, respectively, of equity. However, the proportion of high risk assets to equity remains significant, particularly at the PIL level, at 143% as at YE 2014 (YE13: 163%), albeit that this is the lowest figure for 5 years. Within PIL's high risk assets, the largest holdings are equities (44%), not rated/non investment grade fixed income securities (20%), real estate (19%) and investments in associates (18%).

Furthermore, at the PNLI level Moody's notes the historically high equities concentration in the Finnish market, and the meaningful exposure to financials in the corporate bond portfolio which has increased further in 2015 and represented at 9M 2015 35% of the total investment portfolio at fair value. More positively, we note that as at the end of 2014, the overall direct exposure to sovereign debt in peripheral countries had further reduced and at 9M 2015 equities exposure reduced further to 6% (7% at YE2014) of the total investment portfolio at fair value. Notwithstanding this recent improvement, invested asset risk remains higher than for most of PIL's Nordic insurance peers. However, at the PNLI level, invested asset risk (as a % of Solvency Capital) was somewhat stronger (albeit still significant) at approximately 86% as at 9M 2015 (98% at YE2014).

Capital Adequacy: Baa - RELATIVELY LOW TARGET SOLVENCY II RATIO, WITH MEANINGFUL DIVIDEND PAYMENTS TO PARENT A RECENT FEATURE

PNLI is targeting a solvency ratio of 120% on a Solvency II basis by the end of 2015 which Moody's views as relatively low. At YE14, the estimated ratio, excluding the effect of transition provisions, reduced below the target to 117% (YE13: 125%) impacted by lower interest rates and a higher dividend payment. However, at 9M 2015 the solvency ratio increased above the target to 152%. The improvement compared to YE2014 was driven by an increase in the capital base of Eur 237 million to Eur 1,041 million at 9M 2015, which in turn benefitted from the improvement in the technical account. The overall capital base includes the new Tier II subordinated loans issued in Q2 of Eur 85 million. Meaningful dividend payments to its parent have been a recent feature for PIL representing around 79% and 87% of 2014 and 2013 net income respectively, in contrast to capital injections provided to PNLI during 2008.

At YE2014, PIL's gross underwriting leverage (GUL) remains relatively high at around 6.6x (YE13: 6.5x), although reduces to around 4.7x if the difference between fair value and carrying amount of investments is added to equity. This difference is reflected in PNLI's other reported solvency ratio (solvency capital as a % of net earned premium) which increased slightly to 75% (73%). At 9M 2015, the solvency ratio improved further to 78.5%.

Moody's also considers PIL's business to be higher risk than some of its Nordic peers in view of the liability and commercial account orientation, although notes that PIL has consistently delivered bottom-line profits and has meaningful reinsurance cover.

Profitability: A - VERY GOOD PROFITABILITY AND UNDERWRITING PERFORMANCE, ALTHOUGH RELATIVELY LOW SHARPE RATIO

PIL's 2014 five year average return on capital (excluding fair value gains/losses) is an excellent 24% although this is off-set by a relatively low Sharpe ratio (181%), which considers volatility, in the Baa range. Investment gains and losses have caused meaningful levels of volatility in net income, for example in 2011 and 2012; the ROC in 2011 was a low 4% impacted by fair value investment losses. Furthermore, the underwriting environment for Nordic P&C players in recent years has been very favourable. Notwithstanding this, PNLI's recent underwriting performance has been very good with at YE14 a reported operating combined ratio of 84.7% (2013: 86.9%), although this excludes the unwinding of discount and changes in technical bases; the overall combined ratio improved slightly to 91% (91.6%). At 9M 2015 the operating combined ratio improved to 86.3% (89.4% at 9M 2014), and including changes in reserving basis and amortisation on intangible assets arising from the corporate acquisition the overall combined ratio improved to 87.9% (91% at 9M 2014). According to the new model, a change in the discount rate also affects the calculation of operating ratios. The operating ratios for year 2014 have been changed accordingly. PNLI's operating combined ratio was 89.4% at YE2014. At YE14, PIL reported a slightly improved overall combined ratio of 93.2% (2013: 93.5%) which reduces to 90.1% (89.8%) excluding the unwinding of discount.

At YE14, PNLI reported improved earnings before tax of Eur 223m (YE 13: Eur 166m), benefiting from higher investment income and a slightly higher technical result notwithstanding a Eur 62m (YE13: Eur 38m) charge as a result of reducing the discount rate for pension liabilities from 2.8% to 2.5% (YE13: from 3.0% to 2.8%). At 9M 2015, PNLI reported earnings before tax of Eur 218m (Eur 190m at 9M 2014), driven by a further improvement in the combined ratio. Earnings before tax at fair value reduced to Eur 110 m (Eur 202 m) impacted by the Eur 108 m change in fair value reserves due to higher long-term interest rates. Profitability was negatively impacted by a Eur

48m charge as a result of the further reduction of the discount rate for pension liabilities to 2.28% (average at end-September) from 2.5% at YE2014. OP Financial Group changed the valuation model for non-life insurance liability in Q1 2015 in such a way that it takes account of a change in the discount rate as one continuously updated variable of an accounting estimate.

Overall, Moody's considers profitability to be consistent with an A rated company, and going forward, Moody's expects Pohjola to continue to benefit from the relatively stable market conditions in Finland, and its underwriting performance to remain good.

Reserve Adequacy: A - RELATIVELY PREDICTABLE RESERVING ALTHOUGH EXPOSURE TO LONGER-TAIL LINES OF BUSINESS

The reserve adequacy metric is good, driven by a small net reserve deterioration on a weighted average basis of 0.5% of opening net reserves over the last five years, based on IFRS reserve triangles for the 2005-2014 accident years. We note that in 2014 claims development was positive with a reserve release of Eur 1m. However, Moody's notes the presence of longer-tail lines which presents the challenge of associated reserving risk. Moody's also notes that there were methodological changes in the reserving process during 2010 which affected the 2009 vs. 2010 comparative figures. As has been seen in recent years, PNLI's reserves are vulnerable to longevity risk and a lowering of the discount rate, the former for example negatively impacting the 2010 combined ratio by 3% points. In light of the low interest rate environment, we expect further discount rate reductions following the progressive reductions from 3.0% to 2.8%, 2.8% to 2.5% and 2.5% to 2.28% in 2013, 2014 and 9M 2015 respectively which led to Eur 38m, Eur 62m and Eur 48m pre-tax charges.

Financial Flexibility: A - EXCELLENT METRICS ALTHOUGH INCREASED LEVERAGE AND ACCESS TO CAPITAL MARKETS MORE RESTRICTED THAN LISTED PEERS

Overall financial flexibility is considered good. Financial leverage remained low at around 9% at YE14, with earnings coverage consequently excellent. Financial debt includes a Eur 50 million internal subordinated loan issued during 2008 to improve the solvency position. During Q2 2015 PIL issued a new Eur 75 million Tier II subordinated loan to replace equity. Including the new issuance, adjusted financial leverage on a pro-forma basis at YE2014 increases to approximately 21%.

Moody's notes that on a stand-alone basis, none of the Pohjola non-life companies are listed in their own right. Therefore, access to capital is not viewed as comparable to larger European players.

Other considerations

Nature and Terms of Implicit Support

The A3 IFSR of PIL receives no uplift as a result of its ownership by OP Financial Group, given the a3 BCA of the banking operation. The adjusted a3 BCA of Pohjola Bank (including cooperative support) and the a3 BCA of OP Cooperative, which is intended to directly own Pohjola's non-life business in the future, are used as a reference point for the maximum rating of PIL. The integration to-date of Pohjola's non-life business into Pohjola Bank and OP Financial Group has been successful and well-managed. However, OP Financial Group's support mechanism in which all the member banks provide each other with joint and several guarantees providing immediate and direct support in case of distress, does not cover, by law, insurance operations.

Rating Factors

Pohjola Insurance Ltd[1][2]

Financial Strength Rating Scorecard	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**	**Score**	**Adjusted Score**
Business Profile								**A**	**Baa**
Market Position and Brand (25%)								**Aa**	**A**
- Relative Market Share Ratio			**X**						
- Underwriting Expense Ratio % Net Premiums Written	**15.5%**								

Product Focus and Diversification (10%)								**A**	**Baa**
- Product Risk			**X**						
- P&C Insurance Product Diversification		**X**							
- Geographic Diversification						**X**			
Financial Profile								**A**	**A**
Asset Quality (10%)								**Aa**	**A**
- High Risk Assets % Shareholders' Equity				**142.7%**					
- Reinsurance Recoverable % Shareholders' Equity	**16.1%**								
- Goodwill & Intangibles % Shareholders' Equity	**9.6%**								
Capital Adequacy (15%)								**Baa**	**Baa**
- Gross Underwriting Leverage				**6.6x**					
Profitability (15%)								**A**	**A**
- Return on Capital (5 yr. avg)	**24.2%**								
- Sharpe Ratio of ROC (5 yr. avg)				**181.3%**					
Reserve Adequacy (10%)								**A**	**A**
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)			**0.5%**						
Financial Flexibility (15%)								**Aaa**	**A**
- Financial Leverage	**9.4%**								
- Total Leverage	**9.4%**								
- Earnings Coverage (5 yr. avg)	**48.7x**								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								**Aaa - A**	**Aaa - A**
Aggregate Profile								**A1**	**A3**

[1] Information based on IFRS financial statements as of Fiscal YE December 31 [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis

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