MOODY'S INVESTORS SERVICE

CREDIT OPINION
4 July 2016

Update

Rate this Research

RATINGS

OP Insurance Ltd

| | |
|---|---|
| Domicile | Finland |
| Long Term Rating | A3 |
| Type | Insurance Financial Strength |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information.The ratings and outlook shown reflect information as of the publication date.*


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# OP Insurance Ltd

## Semi-Annual Update

## Summary Rating Rationale

Moody's A3 (stable outlook) insurance financial strength rating (IFSR) on OP Insurance Ltd (OPIL) reflects OP Insurance'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 OPIL, which represents the vast majority of OP 's non-life insurance business (OPNLI), 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 OPNLI is accounted for by OPIL 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 OPIL. Since it has acquired the minority shares in OP Corporate Bank, which currently owns OPIL, OP Cooperative intends transferring ownership of the Non-life Insurance directly to itself in the future, while it has already transferred 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 4 April 2016, the business names of OP Financial Group's main operating companies have also been renamed under the OP brand. Therefore the Banking, Non-Life insurance, Wealth Management and Property Management businesses have been renamed respectively OP Corporate Bank plc, OP Insurance Ltd, OP Asset Management Ltd and OP Property Management Ltd. As part of the reorganization of the banking activities the Group decided to abandon the plan to merge the two banking operations, OP Corporate Bank plc and Helsinki OP Bank Ltd. Helsinki OP Bank Ltd has been converted from a limited liability company to a cooperative bank effective from 1 April 2016 and it has been renamed Helsinki Area Cooperative Bank (OP Helsinki).

On June 10 2016 OP Financial Group announced an updated long-term strategy aimed at transforming the group from a plain financial services provider into a diversified services company with a strong financial services expertise. The business diversification will involve expanding the Health and Wellbeing business which is intended to become the Group's fourth business line alongside Banking, Non-Life Insurance and Wealth Management.

At Q1 2016, OPNLI's business, which is almost exclusively conducted in Finland, was split, in terms of net earned premiums, 54% private customers, 42% corporate customers, with the remaining 4% from the Baltic States.

On 15 May 2015, OPIL'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 OPIL to OP Cooperative from OP Corporate Bank

» Potential for reserve volatility with OPNLI'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

» Weakening of Finland's economy with a potential negative impact on growth prospects and profitability for Non-Life insurance products

» Evolution of Finnish Competition and Consumer Authority's investigation on OP Financial Group's market position in retail banking services and pricing of non-life insurance products

## Factors that Could Lead to an Upgrade

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

» An upgrade of OP Financial Group's BCA

» A material reduction in high risk assets

» Meaningful geographic and product line diversification without sacrificing profitability

## Factors that Could Lead to a Downgrade

Negative pressure could arise from:

» A downgrading of OP Financial Group'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

## Key Indicators

Exhibit 1

| OP Insurance Ltd. [1] [2] | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| **As Reported (Euro Millions)** | | | | | |
| Total Assets | 3,710 | 3,454 | 3,205 | 3,054 | 2,847 |
| Total Shareholders' Equity | 563 | 441 | 392 | 372 | 256 |
| Net income (loss) attributable to common shareholders' | 197 | 228 | 150 | 216 | 23 |
| Gross Premiums Written | 1,257 | 1,259 | 1,149 | 1,033 | 949 |
| Net Premiums Written | 1,209 | 1,205 | 1,093 | 984 | 895 |
| **Moody's Adjusted Ratios** | | | | | |
| High Risk Assets % Shareholders' Equity | 129.0% | 142.7% | 163.1% | 150.1% | 180.9% |
| Reinsurance Recoverable % Shareholders' Equity | 13.9% | 16.1% | 15.4% | 15.7% | 23.7% |
| Goodwill & Intangibles % Shareholders' Equity | 9.5% | 9.6% | 10.6% | 10.5% | 8.5% |
| Gross Underwriting Leverage | 5.5x | 6.6x | 6.5x | 6.0x | 6.6x |
| Return on avg. Capital (1 yr. avg ROC) | 26.0% | 35.7% | 24.2% | 36.8% | 4.0% |
| Sharpe Ratio of ROC (5 yr. avg) | 192.0% | 181.3% | 182.0% | NA | NA |
| Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg) | 0.4% | -0.2% | 1.8% | -0.2% | 0.8% |
| Financial Leverage | 15.1% | 9.4% | 9.3% | 9.3% | 9.9% |
| Total Leverage | 15.1% | 9.4% | 9.3% | 9.3% | 9.9% |
| Earnings Coverage (1 yr.) | 42.3x | 73.8x | 50.7x | 66.8x | 6.8x |
| 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
*Source: Company reports, Moody's Investors Service*

## Notching Considerations

Not applicable.

## Detailed Rating Considerations

Moody's rates OPIL 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 OP 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 YE2015, OPNLI's relative market share metric (of which OPIL 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 OPNLI will be to increase its market share meaningfully without compromising profitability. Notwithstanding its strong market position, OPNLI 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.

Furthermore Moody's notes that underwriting expense as percentage of net written premiums has slightly increased in 2015 for the first time since 2010 to 16.1% from 15.5% in 2014, driven mainly by higher acquisition costs.

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 (43%) and Liability orientation (57%), 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 72% 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 OPIL's overall asset quality to be good, albeit high risk assets remain elevated at OPIL. At YE 2015, goodwill/intangibles and reinsurance recoverables only represented around 9%/14%, respectively, of equity. However, the proportion of high risk assets to equity remains significant, particularly at the OPIL level, at 129% as at YE 2015 (YE 2014: 143%). Within OPIL's high risk assets, the largest holdings are equities (46%), not rated/non-investment grade fixed income securities (21%), real estate (18%) and investments in associates (17%). The improvement in asset quality metrics is driven by the 28% increase in reported shareholders' equity which does not deduct, compared to previous years, the proposed dividend for 2015. After deducting the dividend, high risk assets, reinsurance recoverables and goodwill/intangibles increase respectively to 157%, 17% and 12% of equity.

Furthermore, at the OPNLI level Moody's notes the historically high equities concentration in the Finnish market, and the meaningful exposure to financials, including banks subordinated debt, in the corporate bond portfolio which has increased further in 2015 and 2016 YTD and represented at Q1 2016 36% of the total investment portfolio at fair value. More positively, we note that in recent years the overall direct exposure to sovereign debt in peripheral countries has materially reduced and at Q1 2016 equities exposure was stable at 7% of the total investment portfolio at fair value. Overall, invested asset risk remains higher than for most of OPIL's Nordic insurance peers. However, at the OPNLI level, invested asset risk (as a % of Solvency Capital) was somewhat stronger (albeit still significant) at approximately 99% as at YE 2015 (98% at YE2014).

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

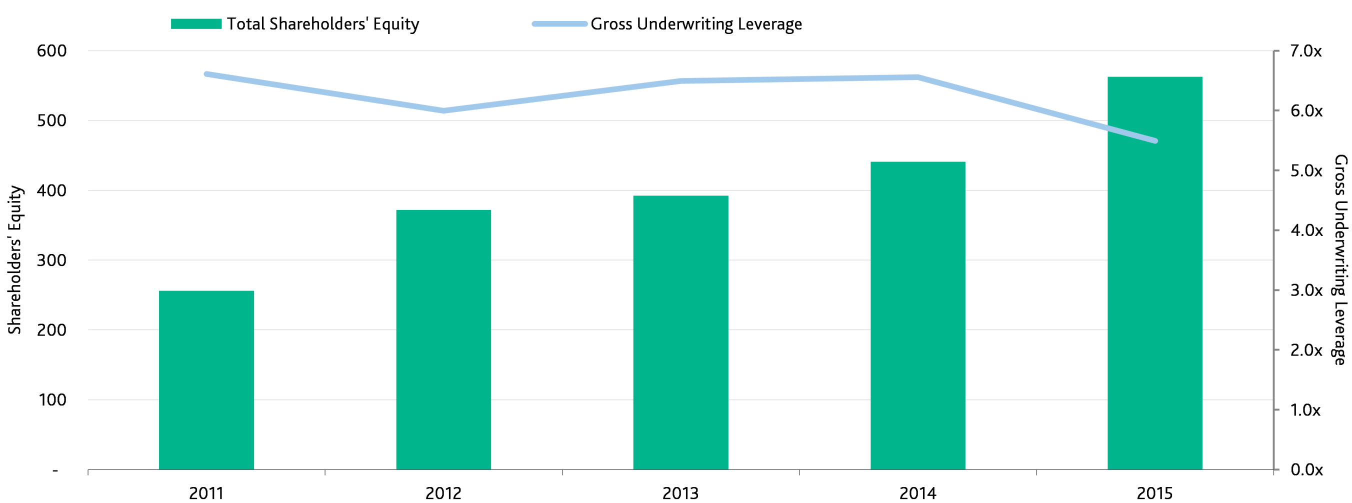
OPNLI is targeting a long term solvency ratio of 120% on a Solvency II basis (excluding transitional provisions) which Moody's views as relatively low. At YE 2015, the Solvency II ratio (excluding the effect of transitional provisions and including OVY Insurance Ltd) increased to 146%, after falling below the target level at YE 2014 to 117%, due to the combined impact of lower interest rates and a higher dividend payment. Including the effect of transitional provisions Solvency II ratio at YE 2015 was 165%.

Excluding OVY Insurance Ltd, on a like for like basis compared to YE 2014, the Solvency II ratio increased at YE 2015 to 139% without the effect of transitional provisions (158% including transitional provisions), driven mainly by an increase in the capital base, 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 2015 of Eur 85 million. At Q1 2016 the Solvency II ratio was 144% excluding the effect of transitional provisions and including OVY Insurance Ltd (166% including transitional provisions). Excluding OVY Insurance Ltd, at Q1 2016 the Solvency II ratio was 137% without the effect of transitional provisions (160% including transitional provisions).

Meaningful dividend payments to its parent have been a recent feature for OPIL representing around 66%, 79% and 87% of 2015, 2014 and 2013 net income respectively, in contrast to capital injections provided to OPNLI during 2008. Moody's notes that for the 2015 results OPIL's board of directors proposes to distribute a dividend of Eur 130 million which, in contrast to previous years, was not deducted from shareholders' equity at YE 2015; on a life for like basis shareholders' equity declined by 2% attributable to the repayment of equity capital of Eur 75 million following the issuance of the Tier II subordinated debt. Including the equity repayment the total payout ratio in 2015 was 104%.

OPIL's gross underwriting leverage (GUL) despite remaining relatively high at around 5.5x improved in 2015 compared to the YE2014 level of 6.6x. After deducting the dividend from shareholders' equity, GUL increased at YE 2015 to 6.9x, although it reduces back to around 5.5x if the difference between fair value and carrying amount of investments is added to equity. This difference is reflected in OPNLI's other reported solvency ratio (solvency capital as a % of net earned premium) which decreased to 70% at YE2015 (75% at YE2014).

Exhibit 2
**Shareholders' Equity and Gross Underwriting Leverage**




*Source: Company reports, Moody's Investors Service*

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

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

OPIL's 2015 five year average return on capital (excluding fair value gains/losses) is an excellent 25% although this is off-set by a relatively low Sharpe ratio (192%), 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, OPNLI's recent underwriting performance has been very good with at YE 2015 a reported operating combined ratio of 87.3% (2014: 89.4%). The overall combined ratio, which includes changes in reserving basis and amortization on intangible assets arising from the corporate acquisition, improved slightly to 88.8% (91% at YE2014). Moody's notes that at the beginning of 2015 OP Financial

Group introduced a new model to calculate operating combined ratio, which now also reflects changes in the discount rate. 2014 figures have been restated accordingly.

At Q1 2016 OPNLI's operating combined ratio deteriorated to 88.6% (87.2% at Q1 2015), and the overall combined ratio deteriorated to 90.2% (88.8% at Q1 2015). At YE 2015, OPIL reported an improved overall combined ratio of 90.2% (2014: 93.2%) which reduces to 87.4% (90.1%) excluding the unwinding of discount.

At YE 2015, OPNLI reported improved earnings before tax of Eur 259m (YE 2014: Eur 223m), benefiting from a stronger technical result notwithstanding a slightly lower investment result and a Eur 62m (YE 2014: Eur 62m) charge as a result of reducing the discount rate for pension liabilities from 2.5% to 2.22% (YE 2014: from 2.8% to 2.5%). 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. Earnings before tax at fair value decreased to Eur 171m (Eur 272m at YE 2014) impacted by a Eur 87 m negative change in fair value reserves.

At Q1 2016, OPNLI reported lower earnings before tax of Eur 59m (Eur 66m at Q1 2015), driven by a deterioration of the combined ratio and lower investment result.

Overall, Moody's considers profitability to be consistent with an A rated company, and going forward, Moody's expects OP Insurance to continue to benefit from the relatively stable market conditions in Finland, despite some weakening of its growth prospects, and its underwriting performance to remain good.

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

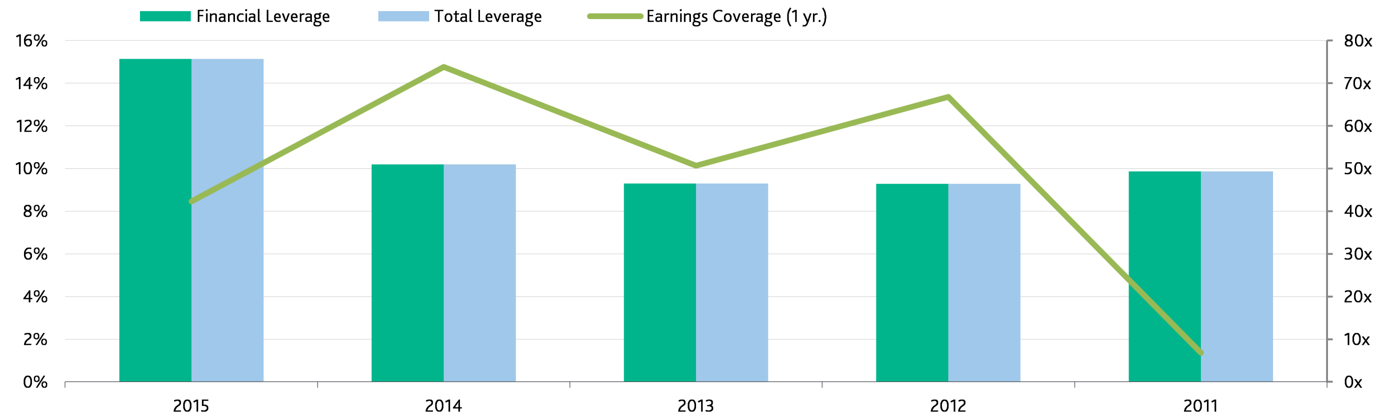
The reserve adequacy metric is good, driven by a small net reserve deterioration on a weighted average basis of 0.5% of opening net reserves over the last five years, based on IFRS reserve triangles for the 2006-2015 accident years. We note that in 2015 claims development was negative with a reserve strengthening of Eur 9m after recording in 2014 a small reserve release of Eur 4m. 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%, 2.5% to 2.22% and 2.22% to 2.15% in 2013, 2014, 2015 and Q1 2016 respectively which led to Eur 38m, Eur 62m, Eur 62m and Eur 13m 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 was relatively low although increased at around 15% at YE2015 (YE2014: 9%), with earnings coverage consequently excellent. Financial debt includes a Eur 50 million internal subordinated loan issued during 2008 to improve the solvency position and a new Eur 75 million Tier II subordinated loan issued during Q2 2015 which replaced equity for the same amount thus increasing leverage by 6% pts. Furthermore, by deducting the 2015 proposed dividend from shareholders' equity, financial leverage increased in 2015 to 18%.

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

Exhibit 3
**Financial Leverage**




*Source: Company reports, Moody's Investors Service*

## Other considerations

Nature and Terms of Implicit Support

The A3 IFSR of OPIL 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 OP Corporate Bank (including cooperative support) and the a3 BCA of OP Cooperative, which is intended to directly own OP Insurance's non-life business in the future, are used as a reference point for the maximum rating of OPIL. The integration to-date of OP non-life insurance business into OP Corporate 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 Methodology and Scorecard Factors

Exhibit 4

| Financial Strength Rating Scorecard [1][2] | 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 | 16.1% | | | | | | | | |
| **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 | | | | 129.0% | | | | | |
| - Reinsurance Recoverable % Shareholders' Equity | 13.9% | | | | | | | | |
| - Goodwill & Intangibles % Shareholders' Equity | 9.5% | | | | | | | | |
| **Capital Adequacy (15%)** | | | | | | | | Baa | Baa |
| - Gross Underwriting Leverage | | | | 5.5x | | | | | |
| **Profitability (15%)** | | | | | | | | Aa | A |
| - Return on Capital (5 yr. avg) | 25.3% | | | | | | | | |
| - Sharpe Ratio of ROC (5 yr. avg) | | | | 192.0% | | | | | |
| **Reserve Adequacy (10%)** | | | | | | | | A | A |
| - Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg) | | | 0.5% | | | | | | |
| **Financial Flexibility (15%)** | | | | | | | | Aaa | A |
| - Financial Leverage | | 15.1% | | | | | | | |
| - Total Leverage | | 15.1% | | | | | | | |
| - Earnings Coverage (5 yr. avg) | 48.1x | | | | | | | | |
| - 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 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
*Source: Company reports, Moody's Investors Service*

## Ratings

Exhibit 5

| Category | Moody's Rating |
|---|---|
| **OP INSURANCE LTD** | |
| Rating Outlook | STA |
| Insurance Financial Strength | A3 |
| **OP FINANCIAL GROUP** | |
| Rating Outlook | STA |
| **OP CORPORATE 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 |

*Source: Moody's Investors Service*

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