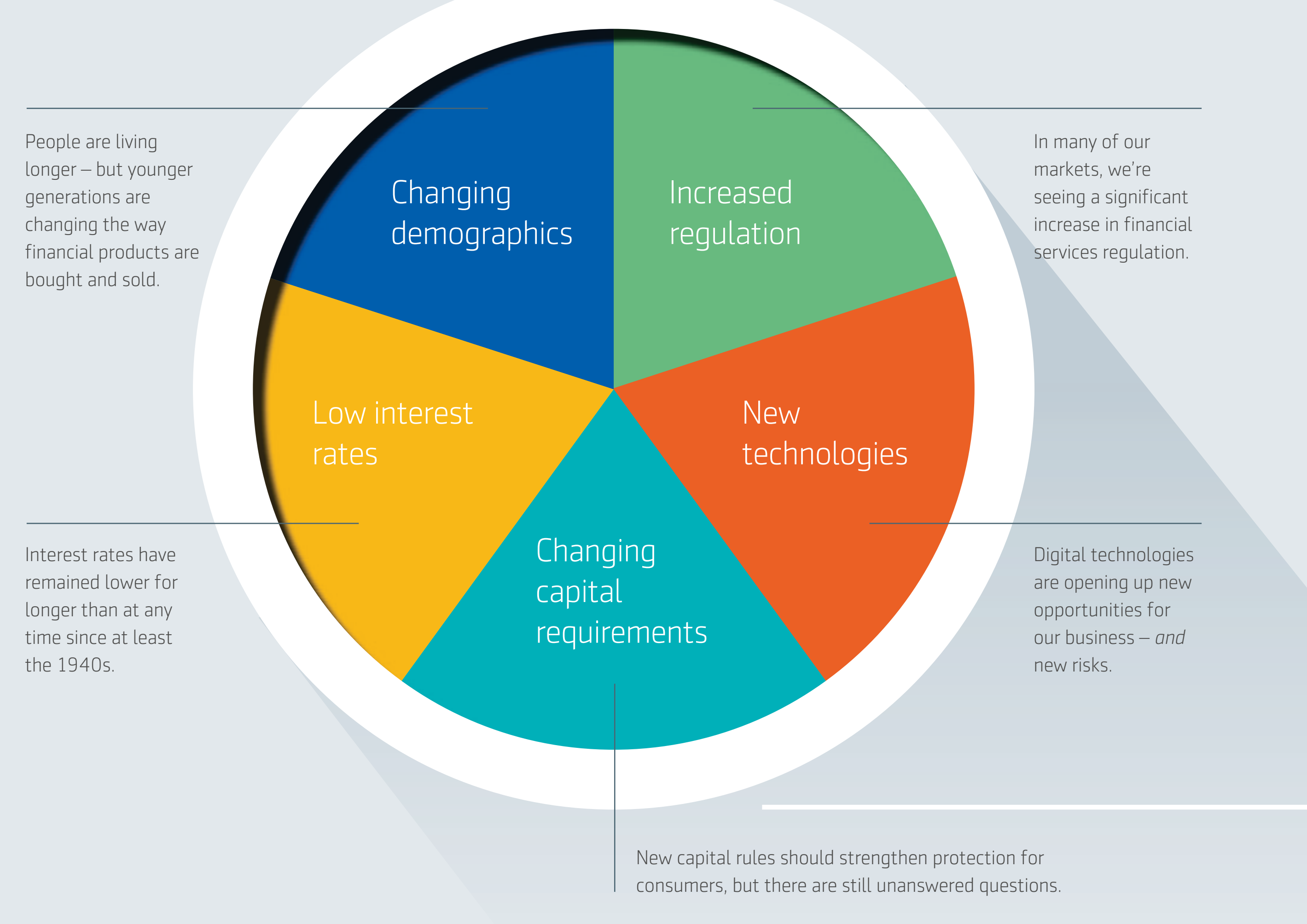
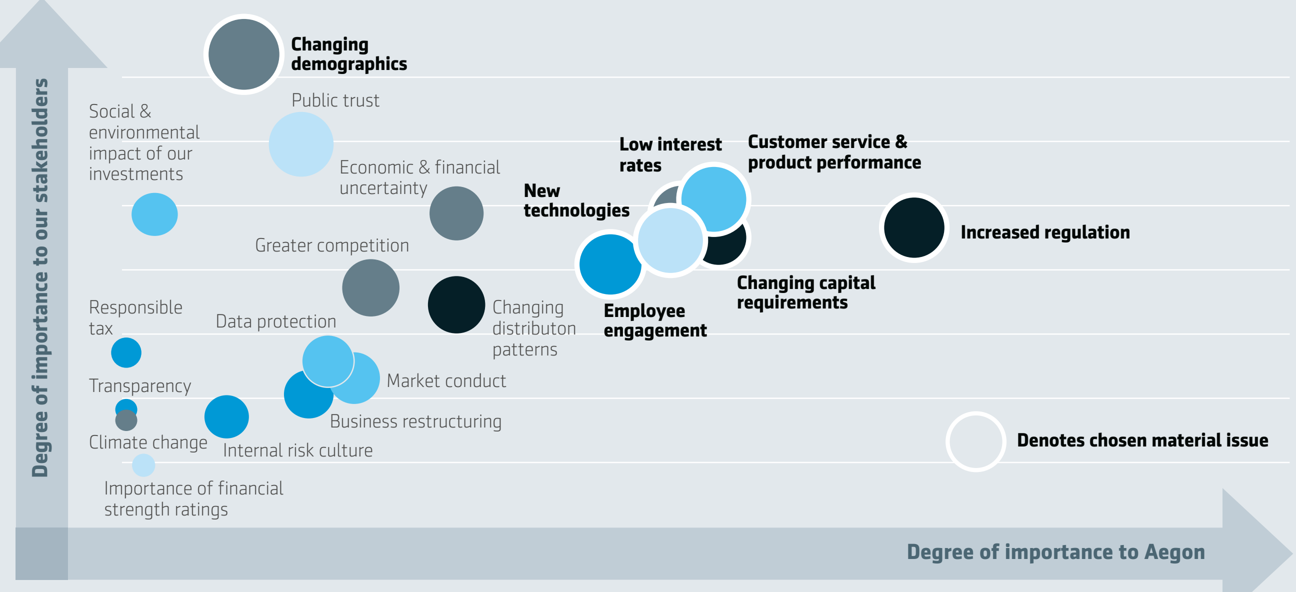
Our operating environment

In the first part of this Review, we'll be looking at how our operating environment is changing. We'll examine five of the most important trends currently facing Aegon and the financial services industry. We'll explain both the opportunities and the risks – and look at what we're doing, as a company, to address them.



Our key trends

Identifying material issues is an important part of our approach to reporting. It's a key principle behind the Global Reporting Initiative's guidelines. And it helps us concentrate in our reporting on what's important – both to our stakeholders and to us. We use a very simple definition: material issues are those we believe have, or will have, a significant long-term impact on our profitability, our operations or our reputation. To identify these issues, we take input from both inside and outside our company. We look at what stakeholders are telling us in our local markets around the world. And at the kinds of subjects discussed online, in the press and on social media. We also conduct a survey of some of our leading stakeholders, using independent consultants Steward Redqueen to ensure impartiality. We ask these stakeholders to assess a series of topics – everything from responsible tax and data privacy to employee engagement and the rise of new technologies. We ask our senior management to go through the same exercise. We then make an assessment of our 'ability to influence' and use the results to compile our materiality matrix (below). This matrix forms the basis of our reporting. It's subject to review by both our Management Board and our external auditor, PwC. Using the matrix, we've pinpointed seven material issues. Two of these issues – Customer Service and Employee Engagement – are covered in detail elsewhere in this report[1]. The five remaining issues we've identified as our key trends, and we'll be examining each in turn over the next few pages.



This matrix is based on surveys of leading stakeholders and members of Aegon's Management Committee carried out in November-December 2014. Participants were asked to rate topics on a scale of 1 to 10 (10 being the most important). The size of each circle above relates to the number of participants selecting that topic as material. 'Ability to influence' is based on Aegon's own assessment (please refer to scale below).

Ability to control or influence

Direct control	Shared control	Strong influence	Some influence	No influence
Issue is entirely within the company's control.	Control of the issue is shared with, or exercised through, another company, organization or third party.	Company has ability to influence the issue within its own businesses and value chain.	Company has ability to influence, but only within its own businesses (not its wider value chain).	Company has little or no meaningful control or influence over the issue.

1 Please see pages 30 and 32 respectively.

Where do we see opportunities and risks?

What's the trend?

Increased regulation of the financial services sector

We've seen a lot of new regulation in recent years. This is partly a consequence of the financial crisis. Regulators have sought to strengthen consumer protection. We've also seen new laws on tax and data privacy. In some of our markets, changes are going much further. The UK is going through a period of unprecedented reform, removing barriers and giving savers more choice. In the UK, the Netherlands and Hungary – for certain products – we've seen the end of commissions to brokers. That's a big step for an industry often reliant on selling through intermediaries. In the US, with the Dodd-Frank Act, we've also seen significant reform of financial regulations.

Growing importance of new technologies

In recent years, we've seen massive growth in online financial services. The insurance industry as a whole still lags behind banking, but it's catching up. According to research, the internet already plays a role in 8 out of 10 life insurance purchases[1]. Increasingly, consumers want to go online. They want to be able to compare prices and benefits. Ultimately, they want to buy life insurance and pensions in the same way they buy other goods and services.

Changing capital requirements for the insurance industry

At the beginning of 2016, the European Union will change its capital rules for insurers. It will be the biggest change since 1973 when the current capital rules were introduced. The new rules, known as Solvency II, are aimed at enhancing consumer protection, and should make it less likely that an insurer will fail. The new rules specifically link the amount of capital insurers must hold to the risks they take on. Regulators will set the bar high: insurers will have to prove they have enough capital to meet their obligations to customers, even under severe stress.

Persistently low interest rates

During the financial crisis, interest rates dropped sharply. They fell to their lowest ever level and, in the seven years since the crisis, have not recovered. The root cause, of course, is poor economic growth. In recent years, central banks around the world have cut rates in an effort to stimulate growth. Now, the US economy is showing signs of improvement, which may mean a gradual tightening in US monetary policy. By contrast, the eurozone remains sluggish and even growth in emerging economies like China, India and Brazil has been decelerating. All of which could limit future rate rises. Aegon's own assumption is that rates will increase, but slowly.

Global aging and changing demographics

We know the world is getting older. By the middle of this century, there will be nearly 1.5 billion people worldwide over the age of 65. Of this total, over a quarter will be more than 80. Global aging is changing the way we live, the way we work and relax, the way we design our cities, and the way we view retirement. With regard to retirement, we're becoming more flexible. Increasingly, we no longer expect to retire at 65. We see retirement as a time for family, travel and new pursuits. At the same time, younger generations are growing up in a very different world – one where there's increased economic and financial uncertainty and where digital technologies have transformed work and home life.

1 Source: PwC (FS Viewpoint, *Life insurance is sold and not bought – but for how long?* February 2013).

What are the opportunities? What are the risks?

We operate in a highly-regulated industry. That means regulatory changes – to tax, for example, or rules governing savings – could have a significant impact on our business – on how we price or sell products, on our risk management, even on the way we organize our company. Changes can bring new competition; they can also open up new markets or affect the insurance industry's role as a provider of long-term capital to the wider economy. In the UK, for example, the government has opened up the pensions market, while in the Netherlands, we've seen banks sell more long-term savings products, as a result of a change in regulation.

Technology is changing the way customers approach financial services. Products need to be simple and easy to understand – suitable for sale online and via mobile devices. More can be sold direct to customers, rather than via intermediaries. Online, we can also provide real-time information, which gives our customers more control over their finances. Selling more online means lower costs, but it also brings more competition, both from online-only providers and from retailers who have ready-made customer bases. Often competition is good for the consumer, but for providers like Aegon it can also drive down prices and squeeze margins. Some products, as a result, become 'commoditized', price competition becomes fierce and providers focus more on add-on services, which can be charged for separately.

Aegon has supported the switch to Solvency II. Applied effectively, we believe the new rules will strengthen consumer protection, and lead to better risk management and governance within the industry. With a year to go before implementation, there are still significant areas of uncertainty. Most large insurers, for example, want to use internal risk models. These will have to be approved by regulators. How businesses outside Europe will be included is still not clear (of particular interest to Aegon with its operations in the US, as well as Asia and Latin America). The new rules could also affect investment choices, and the types of products and services we develop. Ultimately, they could make solvency ratios more sensitive to movements in financial markets.

Why do low interest rates matter to a company like Aegon? The fact is, low interest rates have an impact on our revenue and our earnings. With lower rates, people may save less. Returns on our investments will go down. And we may find returns are not sufficient on their own to meet the minimum guarantees given to some customers. Lower rates mean it's cheaper for us to service our debt, but there's increased risk of a mismatch as we're forced to invest at rates below the level required by our liabilities. Part of the concern is that we've seen such a protracted period of low interest rates; rates now have remained lower for longer than at any time since at least the 1940s.

People are living longer than ever before, and they're having to take more personal responsibility for saving for their retirement. Older populations mean we'll have to pay out more in pensions and other benefits. But they also mean more demand for the products we offer. At the same time, we have to reach out to younger generations, who have a different approach to managing their finances. We'll have to invest more in new technologies, reduce reliance on some of our older products and develop new products that are appealing and easy to access online. To remain competitive, we'll also have to attract new generations into our workforce, build up new skills and offer a modern, connected working environment.

What are we doing about it?

We're adapting our businesses. In the UK, we've positioned ourselves for changes in legislation – by focusing more on workplace pensions and on the increasing number of customers choosing not to work through financial advisors or brokers. We've engaged governments on changes to pension rules and other industry regulations. We've also invested more in businesses where we see real growth; we've expanded our range of mutual funds in the US, and worked hard to grow our pension business. We've also extended our distribution, both direct to the customer and through new partnerships with banks and other intermediaries.

We're investing more in online services. Across the company, we've introduced new websites, apps and online tools that make it easier for our customers to manage their finances. We're also looking to sell more products online. In China, for example, we've teamed up with online retailer tmall. In the UK, we've just launched a new digital platform for customers called Retiready. At the same time, we're investing in new business models, like Knab, our online bank in the Netherlands. Our corporate venture fund has a mandate to invest in new financial technologies – everything from mobile distribution to new financial management platforms. The growth in digital technology has wider ramifications, of course. It brings us much closer to our customers. As a result, we're putting more focus on customer service; we're expanding our online distribution and, where we can, we're bringing down costs.

We're on track for the implementation of Solvency II. Several years ago, we switched to a risk management system in line with the new rules. Since then, we've worked hard embedding this new approach into our internal processes. As a company, we have a clear, well-defined risk governance structure, present at all levels of the organization. Senior management is responsible for deciding our risk appetite, while our internal audit department and Supervisory Board provide an independent check that our risk management is working as intended.

To reduce risk, we match our assets and liabilities as closely as possible, in terms of both their maturity and value. This *asset liability matching* is an important part of our overall capital management. We've also shifted our business so that, proportionally, less of our earnings come from spreads on interest rates and more from fees. We've reviewed our products; we deliberately slowed sales of fixed annuities, for example – in part, because of the inherent interest rate risk. And we've guarded against any sharp rise in interest rates by hedging some of our exposure. We've also taken the opportunity to refinance debt at a lower rate.

We've put more money into products like variable annuities that offer both flexibility and, importantly, a guaranteed income. We've also extended our range of products, and invested in expanding our distribution, both on and offline. In the workplace, new technology enables us to be more flexible. Many of our employees can now work remotely. Where they're needed, we're bringing in new skills – in areas like digital marketing and customer analytics. We've expanded our research into retirement trends; in 2015, we'll be setting up a global Aegon center for retirement studies. And we've taken steps in the Netherlands – through longevity swaps – to reduce our own financial risk associated with increased life expectancy.

How might these issues affect our **financial performance?**

Each of our material issues has implications for Aegon's financial performance. Below, we've mapped each issue against our revenue, earnings and capital, and described the potential impact, both positive and negative:

Revenue

+ With aging, demand for pensions and other long-term savings products should increase. New markets in Asia, Latin America and Central & Eastern Europe are also opening up.
+ Because of new technologies, there'll be more frequent contact with customers. As a result, insurers will know their customers better – which should lead to more effective products and a more consistent customer experience.
+ Aging, new technologies and changes in regulation may open up opportunities – to develop new products, improve existing ones, or reach out to new customer groups.
+ With new technology, products can be improved so they're easier to understand, and more suitable for online or mobile platforms.

– In some cases, changes in regulations could reduce demand for certain products and services. Solvency II also has implications for the kind of products that might be offered.
– Demand from younger consumers may decrease if insurers don't respond quickly enough to changes in customer behavior.

Earnings

+ Increased use of technology should open up more distribution capacity, and push down operating costs. Increased demand, meanwhile, should flow through to increased earnings.
+ Our scale – and diversity – makes it easier for us to cope with an increasingly complex operating environment.

– With new technologies, there's increased risk of 'commoditization' and increased competition, which could mean lower prices and narrower margins. Some products – even some markets – could become unprofitable. Products may have to be modified, or even discontinued.
– Because of low interest rates, returns on some of our investments will go down. Margins may be squeezed, especially on products that offer guaranteed returns.

Capital

+ With low interest rates, it's easier and more cost effective for us to service our company debt.
+ Changes in regulation and low interest rates could provide additional incentive to offer less capital-intensive products.
+ Solvency II should bring better alignment between risk and capital.

– Solvency II could bring an increase in capital requirements – the money we have to put aside, as an insurer, to cover our risks; it may also make solvency ratios more sensitive to movements in financial markets and make it more difficult to invest in long-term assets like infrastructure projects.
– With new technologies, there'll need to be more investment in online distribution and in nurturing new digital skills.

Operating environment

- New technologies and changes in distribution have brought a closer relationship with customers and a better awareness of customer needs. Insurers, however, will have to invest more in new skills like digital sales and customer analytics.
- Changes in regulations may lead to increased uncertainty among investors and customers. Low interest rates, meanwhile, may result in lower overall earnings.
- Competition may reduce prices and margins – but it often means more choice for customers.
- Because of changes in distribution and in regulations, insurers will have to be flexible – strengthening traditional relations with brokers and other intermediaries, while investing in new sales channels, both online and off.