Rating Methodology – General Insurance

CREDIT RATING PHILOSOPHY

CRISL follows structured rating methodologies for each sectors of the national economy and accordingly CRISL has developed distinct Methodology for rating the Claim Paying Ability (CPA) of the insurance companies. The basic philosophy of CRISL CPA rating is arising from the fact that the insurance companies are undertaking huge risk against small amount of premium. The risks are enormous that the entire resources of the company may not be sufficient to handle a single claim in case of general insurance. In view of above, the clients looking for insurance protection should ideally look for insurance claim paying ability of the insurance companies while taking insurance policies. In addition, banks and FIs dealing with the public deposit and investing the resources in trade and property finance should also look for the claim paying ability of the companies in order to determine its risk exposure. This will be more important in case of banking companies after the ensuing Basel-II capital accord implementation in Bangladesh where the capital requirement of the banks will be determined on the basis of the risk undertaken in financing. Therefore, banks will henceforth look into the insurance companies having strong claim paying ability instead of the percentage of discount being offered by the insurance companies. The banks will have to provide more capital if the insurance policies are given to the low rated or unrated insurance companies. Under the above backdrop, the Government made the credit rating mandatory for the insurance companies which will assist the clients to understand the risk undertaken by them in selecting insurance companies. Keeping in view the above, CRISL has developed its own methodology precisely.

CLAIM PAYING ABILITY (CPA) RATING

An insurer's claim paying ability rating is an assessment of an insurance company's capability to meet its contractual obligations to policyholders and other creditors in timely manner after thorough evaluation of its strengths and weaknesses. CRISL also considers an insurer's vulnerability to changing market conditions and upheavals in the greater economy. A CPA rating entails an evaluation of the company's ability to bear that risk as reflected in the strength of its cash flows, liquidity reserves, risk reserves, business concentration, capital strength, investment policy, and prominently the strength of its re-insurance arrangements.

Risk management is an important area of managing an insurance company. Enterprise Risk Management (ERM) has become very important at present as the companies are now finding correlation in many risks that they have historically been managed independently. A company's risk management capabilities are considered in the qualitative assessment in many areas of operation. Financial impairment of insurance companies frequently occurs though an insurance company has not been declared insolvent (technical insolvency). So insurance company's capital and surplus should be maintained in such level to meet legal requirements even at a time when there is no payment schedule for insurance claims. The level of risk faced by an insurer is a function of the type of business being underwritten. Development of efficient internal systems and depth in management also requires an adequate resource base. CRISL analyses the intrinsic fundamental characteristics of the insurer along with the environment aspects in which the company operates.

CRISL'S RATING METHODOLOGY

CRISL's rating is the result of thorough analysis of entire aspects of a company. CRISL analysis magnifies and scrutinizes all the quantitative and qualitative factors likely to affect entity's operation and financial strength without being merely concentrated on the annual reports of the company. The total analysis is clustered into five groups: Corporate Governance, Business Profile, Risk Management, Performances and Balance Sheet Strength.

1.0 CORPORATE GOVERNANCE

Corporate governance ensures the interest of the stakeholders as well as the society as a whole. CRISL analysts have intense observation on the corporate governance practices of the insurance company as well as their deviation from best governance practices. These analyses not only concentrate on the Board practices but also include transparency in disclosure of relevant reliable financial and operational information, information on ownership and control, information on internal processing of management. CRISL views corporate governance as a tool to generate long term economic value for the shareholders and all other stakeholders.

A. Ownership Pattern

CRISL examines the ownership pattern in light with regulatory requirement and also as according to corporate governance practices. Concentration of shareholding of the sponsors, general public and institutions is analyzed to find the ownership structure and their support to the company. Shareholding pattern by individual, family or institutional is also analyzed to assess their relative control on the company.

B. Parent Support

In most of the cases the insurance companies are the affiliates of larger business groups hence any form of implicit or explicit support available from the sponsors and group serves as credit enhancement. For this purpose, strength of the sponsor group as well as diversification of its business lines is analyzed. As assessment of the parent's moral obligation to the ventures in the start-up position or in any distressed position is also analyzed. Therefore, parent's financial strength also plays a pivotal role in assessing the overall support that it would extend to the insurance venture.

C. The Board of Directors

The role of a Board, its composition and shareholding are important considerations in CRISL rating framework. The profiles of the Board members, their contribution to the company in terms of their work affiliation, family or group dominance in the board are also core concentration of CRISL. The future of an insurance company in this industry is heavily influenced by the policies of the board and their support over time. CRISL tries to find the historical support received from the sponsor directors and also from their associated companies in the time of economic distress. Functions of Executive Committee or any other committee comprising board members are important to us to examine the decision making process as well as the supervision to the management. In the light of corporate governance we try to examine the level of involvement of the board in the day to day affairs as well.

D. Regulatory Compliance

Insurance companies are directly regulated by the Chief Controller of Insurance under Ministry of Commerce. Due compliance with the relevant laws and regulations of the country is an obligation applicable for all insurance companies. Any lapses or inconsistencies with the regulatory requirement may lead to legal risk at any point in time. CRISL reviews the above to ascertain whether the company is under any legal or pending cases that may jeopardize the operation in future. In order to ascertain the compliance related issues, CRISL usually demands relevant information from the company.

E. Financial Reporting System

CRISL CPA Rating relies on the audited data, however, after thorough examination on the policy for income recognition, valuation of investment and loss reserve etc. Reported figures are usually verified and suitable adjustments are made to make it more representative and meaningful. Positive marks are also added to the rating depending on the extent of disclosure in the annual reports. Disclosures in the annual report are viewed as an indivisible part of corporate governance.

F. Management Information System

Adequate information technology application in the business operation can streamline the operational activities and reduces the operational risk. CRISL takes into account the adequacy of management information system to generate various management reports which is utilized by the management in timely decision making. CRISL carefully examines the stage of advancement in developing required IT infrastructure and the extent of its use in an insurance company compared to the peer in the industry. Data protection / disaster system is also evaluated in the light of operational risk mitigation.

G. Human Resources Management

CRISL considers professional management team and structured human resources development program as an integral part of general insurance companies. Sufficiency of management personnel in different tiers, experience and competence of management personnel, corporate culture and structure, decision making hierarchy and succession plan are important review areas. Employee job satisfaction is the precondition of the growth of an insurance company. CRISL task also lays on the ground to find the employee turnover in different tiers in each year and the reasons for their departure. External or internal training facilities are used to put high value for efficient work in an insurance company. Sufficient business, administrative and financial delegation of power to the management provides flexibility in their decision making process hence it is considered as a good indicator in CRISL rating. CRISL also looks at the management committees and composition as well as their roles and responsibilities to enhance the day to day business operation.

H. Marketing Strategy

Too many insurance companies are operating in a comparatively small economy. In view of above, the companies are facing stiff competition although the sector is dominated by a few large players while the remaining participants are confined to their respective groups and associated companies. In order to cope with the market competition and to diversify the existing business and product lines extensive marketing approach and agency build up process are considered to be essential. It helps the company to hold its market share and provide strategic advantages over its competitors in the long run. Analysis of future business strategy and marketing plan give CRISL an idea about the business target of the management.

2.0 BUSINESS PROFILE

CRISL places due importance to the business profile of a company in the process of rating. Business profile is influenced by the degree of risk inherent in the company's mix of business, a company's competitive market position, and the depth and experience of its management. CRISL, by and large, considers the business risk in the flowing lines:

Business	Risk Category	Business	Risk Category
Fire	High	Liability	Medium to High
Marine-Hull	Medium	Others	Medium to High
Marine –Cargo	Medium to High	Motor	High
Health	Medium to High	Aviation	High

Management strategy and organizational policy have direct impact on the organizational performance. So the present business world has been promoting the best practice in every aspect of internal management process, corporate governance, risk management, human capital management, information management etc. Though these practices can not be quantifiable in any absolute figure, it can be measured in accordance with their relative rationality from the sectoral best practices and global practices. CRISL has long experience with the different sectoral practices of the economy as well as good affiliation with global practitioners to share their views in the rating process.

A. Market Position

General insurance company can diversify their market exposure in different business lines. So the market share in each line of business and their key competitive advantages in different business are also analyzed. Diversity mitigates risk and hence product and geographical diversity would be evaluated.

B. Re-insurance

Re-insurance arrangements are integral part of insurance risk management. Re-insurance helps to diversify the underwriting risk among a pool of re-insurer and increases an insurance company's underwriting capacity. It also helps to cap the overall loss that could devolve on the primary insurer. CRISL would assess the level of risk retained by the insurance company according to their re-insurance strategy, the re-insurance programs, financial strength & credit profile of re-insurers. The re-insurers' performance can be predicted by the quantum and aging of re-insurance receivables.

The terms and conditions of re-insurance treaty determine the capacity of an insurer to take risks and changes in those terms often indicate an insurer's track record of risk management. An insurer's retention ratio determines the proportion of risk retained by the company. In order to assess the extent of retention, CRISL would understand the re-insurance program for each business segment (quota share treaty, surplus share treaty and facultative treaty) with the re-insurers. In addition, the analysis would attempt to capture the policy regarding sharing of claims in excess of the retention limit. Ideally, an insurer's own retention should be between 40%-60% of gross premium. Unusually high retention levels could signal inadequate re-insurance protection, while low retention could hamper profitability.

C. Quality of Investment Portfolio

An insurance company deploys its fund in different earning and non earning assets. CRISL reviews the quality of the investment portfolio in terms of its composition, return and concentration. Most of the insurance companies, by and large, keep its major portion of the fund in fixed deposit with commercial banks and other financial institutions. CRISL observes the concentration of FDR, their rate of return and maturity break ups. Moreover, CRISL also looks into the quality of investment in equity and other fixed income securities to evaluate overall quality of investment portfolio.

3.0 RISK MANAGEMENT

The functional threshold of CRISL rating work encompasses the evaluation of risk management framework of an insurance company. Principally the higher the risk management practice, the lower the risk and the protection for the stakeholders is more evident. CRISL examines the market risk and operational risk management tools and techniques used by a company.

A. Market Risk

Insurance industry is greatly affected by the market policy. Operational areas are reviewed in relation to its importance in the economy, its size and growth potential (present penetration level and future growth prospects), entry barriers, cyclically within the industry, the stability of underwriting performance as well as the regulatory policies governing the sector. On the regulatory front, CRISL reviews issues such as licensing requirements, the pricing freedom that companies enjoy, underwriting guidelines, investment guidelines, accounting norms, solvency ratio that they must comply with and the like. Different policies regarding tax and VAT issues, mandatory re-insurance & retention ratio, fee structure and so forth are coming to the market discussion.

B. Operational Risk

The operation risk analysis entails an examination of the factors that specifically influence a particular company. CRISL would study the company's risk management systems for both monitoring risks and for evolving re-insurance strategies. In terms of risk management, globally insurance companies offer a range of services that include risk analysis, grading and control, hazard studies, safety audit, risk management training and insurance portfolio analysis. These services help corporate clients to comply with statutory requirements, institute unified risk management policies and ensure optimal insurance costs. Insurance companies that are able to provide these risk management services would be in a position to enhance their competitive strengths and grow business volumes. Ensuring better internal control system is also an important part to reduce internal fraud, inefficiency of operation and increase transparency of operation.

C. Event Risk

Event risk can encompass a variety of sudden or unexpected circumstances that may arise and can potentially impact an insurer's financial strength. When a sudden or unexpected event occurs, CRISL evaluates the financial and market impact to the issuer. For example, the potential exists of major business and distribution disruption associated with significant litigation, the potential for "run-on-the bank" due to loss of a policy-holder/distributor confidence, economic collapse etc.

4.0 PERFORMANCE

A. Financial Performance - Profitability

Profitability of an insurance company is a function of its underwriting and investment strategy. A company's pricing strategy should be commensurate with the risks underwritten which are also an important element that affects the performance of a company in long run and in assessing sustainability in earnings. Management of investment portfolio is very crucial in bolstering an insurance company's overall performance. Though investment income is not a core area of revenue generation but it serves as cushion to reduce the stress of underwriting losses. So CRISL would examine the insurance company's investment strategy with regard to quality, capital appreciation, long-term safety and easy liquidity of invested assets. Diversification of investment portfolio along with single risk concentration limits are important determinants of overall asset quality. While reviewing the financial performance, CRISL puts due weight to the ratios like: Gross Underwriting Margin, Net Underwriting Margin, Pre Tax Operating Margin, Return on Average Assets, Return on Average Equity, Return on Average Investment etc..

B. Operating Performance- Efficiency

Operating performance mainly deals with efficiency related aspects of the company. In order to determine operating efficiency, and business generation, operational costs are also evaluated in relation to the premium generated. Trends on claims and expenses are also assessed. Segment–wise analysis of claims is carried out to determine each business line's impact on overall profitability. The choice of business segments, geographical outreach and diversification of underwritten risk are the key determinants of claim incidence, operating expenditure as well as the company's cash cycle. While analyzing the operating efficiency, CRISL gives due weight to the ratios like Retention Ratio, Expense Ratio, Claim Ratio.

5.0 BALANCE SHEET STRENGTH

Quantitative analysis mostly depends on the available figures in the published annual reports or in the accounts and also from internal database of the respective company. Although the rating assignments are not concentrated on accounting figures rather CRISL's professionals usually come across to the rationality of each figures presented on the annual reports or in accounts. Further breakdown of those figures is one of CRISL's common requirements to unveil the past trend of those figures. In order to reach at a rating decision, a detailed review is done on the key factors of Balance sheet and their stability over the period.

A. Capitalization

Capitalization measures the exposure of a company's solid capital base through injection of fund from shareholders and reserve generation from operation. A highly poorly capitalized company can show a high return on surplus, but might be exposed to a high risk of instability. Strong capitalization enables an insurer to better withstand large underwriting losses and minimize impact of volatility in the income. The new Insurance Ordinance revised the Minimum Capital Requirement (MCR) of TK. 400 million for the general insurance company and Tk. 300 million for Life Insurance Company. However meeting the MCR does not necessarily imply sufficient capital. A high level of internal capital generation enables an insurer to gear up its capital base. Further, CRISL analyses the strength of an insurer's capital base through various leverage ratios measuring the level of business written and technical reserves against the level of capitalization. While determining the level of capitalization, hidden reserves and impairments are also taken into consideration. Furthermore, composition of technical reserves is evaluated to assess the extent to which these are held against payable claims or unearned premiums. In order to see the extent of capitalization, CRISL applies the tests like External Liabilities Ratio, Unexpired Risk Reserve to Net Claim Ratio, Net worth to Total Assets, Exceptional loss Reserve to Net Premium Ratio, Underwriting Leverage etc.

B. Liquidity and Funding

Liquidity measures a company's ability to meet its anticipated short term and long term obligations to policy holders and other creditors. A company's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid. The liquidity position would also be a function of the management's policy of maintaining a treasury portfolio to meet liquidity demands. In order to measure the company's ability to satisfy its financial obligations without having resort to selling long term investments, CRISL reviews its quick liquidity, current liquidity to measure the proportion of company's total liabilities. The primary sources of liquidity include underwriting cash flows, operating cash flows and investment portfolio liquidity. CRISL forms an opinion about the health of the invested asset portfolio in terms of liquidity, impairment if any, concentration of exposure and returns. Quality and liquidity of an insurer's investment portfolio is assessed to determine the level of coverage against its insurance related liabilities.

Insurance companies are expected to have adequate financial flexibility to meet unforeseen contingencies. A line of credit facility from banks to meet short term liquidity requirements and capital commitment from promoters are important sources of financial flexibility. In addition, the analysis would attempt to capture if the insurance company has any "cash call" facility from its re-insurer(s) to meet any large claims. Such a cash call facility is an additional comfort and a positive feature of the company's overall re-insurance program.

CRISL RATING SCALES AND DEFINITIONS

INSURANCE CLAIM PAYING ABILITY RATING

RATING	DEFINITION
AAA Triple A	Highest claims paying ability. Risk factors are negligible and almost risk free.
AA+, AA, AA- Double A	Very high claims paying ability. Protection factors are strong. Risk is modest, but may vary slightly over time due to underwriting and/or economic condition.
A+, A, A- Single A	High claims paying ability. Protection factors are good and there is an expectation of variability in risk over time due to economic and/or underwriting conditions.
BBB+, BBB, BBB- Triple B	Good claims paying ability. Protection factors are good. Changes in underwriting and/or economic conditions are likely to have impact on capacity to meet policyholder obligations than insurers in higher rated categories.
BB+, BB, BB- Double B	Average claim paying ability. Protection factors are average. The companies are deemed likely to meet these obligations when due. But changes in underwriting and/or economic conditions are more likely to weaken the capacity to meet policyholder obligations than insurers in higher rated categories.
B+, B, B- Single B	Inadequate Claim paying ability. Protection factors are weak. Changes in underwriting and/or economic conditions are very likely to further weaken the capacity to meet policyholder obligations than insurers in higher rated categories.
CCC+, CCC, CCC-	Uncertain claims paying ability. The companies may not meet these obligations when due. Protection factors are very weak and vary widely with changes in economic and/or underwriting conditions.
CC+, CC, CC-	Poor claims paying ability. Adverse underwriting or economic conditions would lead to lack of ability on part of insurer to meet policyholder obligations.
C+, C, C-	Very high risk that policyholders obligations will not be paid when due. Present factors cause claim paying ability to be vulnerable to default or very likely to be default. Timely payment of policyholder obligations possible only if favorable economic and underwriting conditions emerge.
D	Insurance companies rated in this category are adjudged to be currently in default.