Rating Methodology – Life / Health Insurance

CRISL'S CLAIM PAYING ABILITY (CPA) RATING PHILOSOPHY

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.

CRISL'S RATING METHODOLOGY

CRISL's rating is the result of thorough analysis of entire aspects of a company. From analytical point of view CRISL considers Risk Exposures, Defensive characteristics and competing position of an insurance company which are the critical areas that need to be reviewed meticulously. 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, institutions and general public 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 operation.

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 sponsoring 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. 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. CRISL also look into the composition of the Board to investigate the participation of directors from the sponsors, shareholders and policyholders. The future of an insurance company in this industry is heavily influenced by the policies of the board and their support over time. Functions of Executive Committee, Claim 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, CRISL tries 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 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. The business profile covers the areas to satisfy the question- why the company has been enjoying competitive advantages? The insurers having string balance sheets and acceptable risk exposure can provide high claim paying ability. However, for high level of financial strength to be maintained over the long run, the company must have a sustainable competitive advantages. Strength and weaknesses in the following areas can have an impact on the competitive advantages of a company. The factors are Distribution capabilities, marketing and sales effectiveness, franchise value, market share, brand name recognition, unique product and value added services, administrative capabilities, expense efficiencies, well executed investment strategy.

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. 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. The analysis would attempt to capture the policy regarding sharing of claims in excess of the retention limit. Unusually high retention levels could signal inadequate re-insurance protection, while low retention could hamper profitability.

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. Though all life/health/pension companies considers various risks as part of their normal business and underwriting activities, CRISL believes that the following most greatly increase a life / health pension insurers risk exposures: Concentration of risk, liquidity risk, asset liability mismatch risk, inflation risk, exposure of high risk investment, high expense loads, underwriting risk-mortality and morbidity exposure, regulatory compliances, slow growth and abnormal growth etc. In order to overcome the above risk exposures, the defensive characteristics required are capital strength, internal capital generation, financial flexibility and access to outside sources of fund, ability to earn enough profit to ensure adequate return on capital, underwriting quality and capability, liquid and high quality investment, adequate reinsurance protection, diversification of business and reserve against claim. In addition to the above, CRISL also examines the market risk and operational risk management tools and techniques used by a 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. The real risk of an insurance company is not the risk of insolvency rather the toughest risk in the market is the ERM. The questions, can the company survive as a viable business? Does it have critical mass? Positioning? Size? a niche market it can survive in? The survival in the competitive environment will hinge on two critical intangible factors- quality of management and effectiveness of the distribution system. The companies that will survive in future will have to have firstly good management and integrity of operation within competitive parameters and secondly, be able to move products. 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 require an adequate resource base. CRISL analyses the intrinsic fundamental characteristics of the insurer along with the environment in which the company operates.

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 risk review.

B. Operation 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 is 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. Unlike general insurances, the financial performance of life insurances are measured by the surplus generated from the gap between actuarial valuation of liabilities and life fund. While reviewing the financial performance, CRISL also puts due weight to the ratios like: Policyholders Surplus to Net Premium, Surplus on Assets, Shareholders' Surplus on Equity, Return on Investment, Incremental Surplus to Incremental Life Fund etc.

B. Operating Performance- Efficiency

Operating performance mainly deals with efficiency related aspects of the company. The overall operating efficiency of life insurance companies depends, to a great extent, on the control of management expenses, increment of life fund against net premium written, employment of fund to earning assets, reduction of policy lapse etc. 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.

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 works are not concentrated to produce 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 and Solvency:

Capitalization measures the exposure of a company's solid capital base through injection of fund from shareholders and reserve generation from operation. A 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 has revised Minimum Capital Requirement (MCR) of TK. Tk.300 million for Life Insurance Company. However, meeting the MCR does not necessarily imply sufficient capital. Unlike general insurances, life insurances absorb the liabilities of the policyholders till the maturity. Thus, the prerequisite for long run sustainability of a life company is the creation of life fund from the premium income and the investment return. In view of the above, CRISL analyses the strength of an insurer's long run sustainability through various indicators.. In order to see the extent of sustainability, CRISL applies different ratios like Total Unadjusted Net Liabilities to Life Fund, Internal Life Fund Generation, and Incremental Net Liability to Incremental Life Fund 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.

END

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 favourable economic and underwriting conditions emerge.
D	Insurance companies rated in this category are adjudged to be currently in default.