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INTRODUCTION – Rating Process for General Insurance Institutions

OVERVIEW

ECRL's insurance financial strength ratings assess the financial security characteristics of an insurance company with respect to its ability to meet its obligations to policyholders in accordance with the terms of their insurance contracts. When rating insurance companies, ECRL's analyst considers macroeconomic factors, industry dynamics including regulatory issues, and individual company performance. The analyst examines how economic factors affect the company's growth opportunities and financial condition. In-depth analyses are then made of the insurer's business, management and corporate strategy, operating and underwriting performance, investment, liquidity, capitalization, reserves and reinsurance arrangements.

ECRL's rating methodology incorporates the combined inputs of quantitative financial analyses as well as qualitative assessments based on interactive discussions with senior management. Competition within the industry is intense with the existence of 43 general insurers; the top 10 companies accounting for half of industry gross premiums. Ambitious growth strategies and market share preoccupation could tempt insurers to undercut rates and compromise on underwriting practices that are inconsistent with the risks they are assuming.

Another trap that insurers may fall into is embarking on certain widely-demanded products before acquiring the necessary technical underwriting expertise e.g. medical insurance. Such inadequacies and pricing errors will inevitably be exposed in the subsequent period's loss ratio. Positively, motor insurance enjoys a captive market due to the mandatory requirement for insurance cover to be taken by motor vehicle owners in respect of any liability for death or injury caused to third parties. Not surprisingly, motor insurance constitutes the largest segment of general insurance products, representing 55% of total net premiums. Fire insurance, which is voluntarily procured, is the next most important category of general insurance products.

Fire policies cover destruction and damage to the insured property from fire or lightning and may also cover consequential loss of profit. Marine, aviation and transit insurance (MAT) is the third general insurance category due to two factors: it requires specialist underwriting expertise which is lacking in Bangladesh and it is an area subject to international competition. Under the miscellaneous class, the more prominent products are workmen's compensation insurance, personal accident policies, public liability insurance, theft and burglary. Growth in the construction and industrial sectors has also created the demand for contractors' all risks policies, engineering insurance and performance bonds.

INDUSTRY REVIEW

ECRL considers the following in assessing the outlook for the general insurance market;

- the pricing environment and phase in insurance cycle at present;
- trends in gross and net premiums;

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- growth rates for main lines of business;
- distribution profile of main business lines and trends in distribution of general insurance products by various channels (intermediary, direct, bank, other)
- potentially significant imminent and pending regulatory changes such as new solvency requirements;
- effect of the macroeconomic environment on demand for insurance;
- industry underwriting profitability and the direction of key drivers for non-life profitability such as investment returns and loss and expense ratios;
- trends in loss and combined ratios by business line; and
- new entrants and capital adequacy trends.

It is important to examine a company's strategies and performance in the context of its operating environment, the understanding of which is derived from a review of its industry.

BUSINESS REVIEW

This section defines the key characteristics of organizational structure and activity which constitute the company's competitive strengths and weaknesses. The assessment focuses on the company's current and potential revenue generating capabilities. However, the negative aspects that could hurt future results must also be highlighted – threat from existing competition, threat from new entrants particularly from the liberalization of the industry to foreign players, and threat of rival products (from the banking and unit trust sectors). Market positioning of the insurer and market share by major product lines. The analyst must understand how this market share was obtained – would be more sustainable if obtained through the company's competitive advantage rather than rate cutting. The analyst looks at the company's five-year growth trend against the industry's (measured by premiums written). If rapid growth was recorded, understand the reasons and determine whether it is sustainable. Moderate growth that is sustainable is viewed more positively than rapid growth that is not sustainable. If revenues are declining, evaluate their impact on the insurer's ongoing financial strength.

Business mix – This is an evaluation of the products or classes of insurance marketed and underwritten by the company. The analyst would also analyze the distribution of net premiums written into the respective classes of insurance and a five-year trend analysis, highlighting reasons for major changes to product segmentation. Does the company have a strategic and sustainable competitive advantage in a particular product line? How well diversified is the product mix?

Underwriting standards and claims management – The financial performance of the company is dependent on the quality of the business accepted, and, therefore, the analyst needs to review the insurer's underwriting guidelines. Proper claims control will alleviate fraudulent claims, but the insurer must also ensure that claims are paid promptly and fairly. Claims chiseling will result in an unfavorable reputation and a loss of market share, but consistent overpaying of claims will weaken its financial position. The mainstay of the general insurance industry's distribution network is the agency system. The analyst should check on heavy dependence on a few agencies to provide the bulk of the business. Insurers with bank group affinities can source a sizeable portion of their business through bank assurance products. Internet insurance (which is open to all insurers) also serves as a cost-effective alternative distribution channel. Other competitive strengths include expense efficiencies, strong distribution capabilities, and quality of service, specialized underwriting

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skills and franchise value/name recognition. For a firm's long term success, it is crucial that it differentiates itself from its competitors. Firms without a sustainable competitive advantage are viewed least favorably.

MANAGEMENT AND CORPORATE STRATEGY

A review of management and corporate strategy considers a company's strategic positioning, which is how it approaches the market, its organization structure, operational effectiveness and financial risk tolerance. In doing this assessment, we look backward and forward. A company may have a strategy that has served it well in the past, but the market has changed and they are no longer positioned for success going forward. We ask whether the company's strategy makes sense, given the context of the marketplace. ECRL also considers whether the company has the right management team to affect that strategy. Other questions we ask ourselves include:

Does a company's management team take on undue financial risk in order to implement its strategy?

What has management done historically? What's its track record?

Meetings with senior management can reveal the company's readiness to embrace challenges/threats. What are the company's plans with respect to (a) increasing efficiency and productivity, (b) enhancing technical skills in areas such as underwriting, information systems and asset management, (c) product innovation, and (d) improving service quality? An assessment is made of management's ability to meet new products from competitors, as well as its own ability to bring innovative new products to the market place. How much resources are put into research and development of new products and markets?

Operational effectiveness is an assessment of a company's ability to execute its strategy. What is management's track record in exercising strong control over operations; what are the internal audit controls used? Chief Controller of Insurance continually emphasizes on the improvement of handling general insurance claims, particularly in the fair treatment of claimants and increasing efficiency in the processing and settlement of insurance claims. Get an idea of the insurer's position in this area of claims handling.

Number of complaints from policyholders and the nature of complaints- How long does it take for a claim to be settled from the time a claim report is made? Understand management's financial risk tolerance and philosophy on reserving practices, use of reinsurance, assumption of external debt, allocation of invested assets and measures of capital adequacy. Management may have a higher risk tolerance in one area which needs to be tempered in other areas for an overall viable business strategy. For instance, a higher risk underwriting portfolio should be counterbalanced by a lower risk investment strategy or stronger capitalization. Other organizational considerations include: frequent and significant changes in senior management, over-reliance on certain individuals, high staff turnover, unrealistic forecasts which put management under undue pressure, rapid expansion of the business beyond the administrative capabilities of management, and a high incidence of official public complaints.

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OPERATING AND UNDERWRITING PERFORMANCE

Evaluate the insurer's operating performance trend over a 5-year period. Operating performance is an indicator of its ability to grow the capital base and support business growth. Stability in operating performance is viewed more favorably than a strong performance in a particular year, if that performance is not sustainable. Operating statistics for the past five years, for each class of business, are analyzed for any significant difference in:

- Gross premium written. Comprises direct premium as well as reinsurance acceptances.
- Net premium written. The amount of premium retained by the company after reinsurance.
- Underwriting expenses. Net claims incurred agency commissions and management expenses. Net claims incurred are net claims paid after accounting for changes in provision for outstanding claims during the year.
- Total investment income

Underwriting profits are generated when premiums exceed claims and administrative expenses. An insurer's underwriting performance is measured by the combined ratio which is the aggregate of the loss ratio and the expense ratio. The loss ratio is the ratio of net claims incurred to earned premium income. The loss ratio data for each class of business is compared with the industry loss ratio for the same class of business. The expense ratio is the ratio of the sum of agents' commission and management expenses to net premium written. A low expense ratio can be a competitive pricing tool to an insurer. A combined ratio below 100% produces an underwriting profit, and one above 100% translates into an underwriting loss. Loss ratios typically escalate during an economic slowdown due to higher crime-related claims i.e. burglary, arson, car thefts, and declining premium volumes as policyholders cut back on sums assured. Exchange rate fluctuations may also have an impact on claims cost of imported replacement parts.

When analyzing trends in the loss ratios, understand reasons for aberrations. How does its loss experience compare with its peer average? This could point towards certain competitive advantages or weaknesses. An insurer which has been consistently recording lower loss ratios compared to its peers may have implemented very stringent claims control procedures. However, the downside risk is that if its policyholders perceive that claims are not fully and fairly settled, they may switch insurers upon renewal.

The insurer's underwriting profits are supplemented by investment income in the form of interest, dividends and capital gains on the insurance fund's assets. The operating ratio, which is the combined ratio less investment income ratio (investment income divided by earned premium income) measures overall profitability (underwriting and investing) of the insurer.

INVESTMENTS

Premiums of an insurer that are not allocated to payments of claims, agents' commissions or management expenses, are invested in various types of assets to earn investment income. The major investment classes are:

- Cash and deposits
- Public securities (government and Bonds). Low risk assets.
- Private Debt Securities. Periodic coupon payments, but certainty of these payments and ultimate repayment of principal depends on the credit risk of the issuer, which its rating attempts to represent. FDR which are sold prior to their maturity will either realize a gain or loss, depending on the interest rate environment and rating changes.

• Ordinary shares. Cash flow stems from the periodic payments of dividends, which can be variable, and the market value of shares.
• Loans. Periodic interest payment and principal repayment. Deviations from expected cash flow can be caused by default by the borrower.
• Property. Cash flow is derived from rental income, and can be interrupted by tenant defaults and termination of tenancy.

The investment portfolio is analyzed for credit risk, market risk, liquidity and diversification. The better the liquidity, diversification and quality of assets, the more certain the value to be realized upon their sale, and the lesser the likelihood of default. Credit risk is analyzed by looking at the performance of its loans portfolio (current/delinquent), credit rating and rating downgrades of its PDS portfolio. Market risk is the risk of changes in asset valuation due to changes in market conditions i.e. stock market, interest rates, property prices. Liabilities of general insurers are shorter tail in nature, thus a higher liquidity level is needed of its invested funds. ECRL defines liquid assets as cash and deposits and public securities. Investment diversification should be weighed by asset class, industry sector, and individual investments. Prudent exposure limits to individual borrowers and sectors should be set and monitored to avoid concentration of risk.

ECRL's investment analyses include:

• Investment team's qualifications and experience
• Investment objectives in relation to rate of return, investment selection and portfolio diversification. An insurer's level of risk tolerance is determined by the degree of variability in investment returns that is acceptable to management.
• Historical investment performance is evaluated to determine how well the company's investment strategies are executed.
• The investment manager's stated objective in relation to risk should be compared with the past and present investment strategy in areas of portfolio composition, asset quality and concentration levels.
• Investment philosophy – what is the basis of stock and FDR selection? Credit underwriting criteria for loans?
• Portfolio monitoring and timeliness of portfolio adjustment when actual performance deviates from targets, or expected future returns are unacceptable.
• Portfolio management techniques/risk management – use of financial derivatives to hedge its investment portfolio e.g. options and futures to hedge stock market exposures.

Investment returns and their volatility reflect the insurer's investment risk appetite, the interest rate environment and stock market conditions. The yield on invested assets measures investment income before realized capital gains/losses and tends to exhibit less volatility compared to total investment return, which includes capital gains/losses in its computation. General insurers have to maintain a more liquid investment portfolio, but there is the corresponding trade-off between liquidity and investment returns. To establish prudent investment practices amongst the insurance companies, Chief Controller of Insurance limits the amount of each class of asset held by specifying the maximum amount permitted as "admitted assets". An insurer must hold admitted assets of a value at least equivalent to the margin of solvency, which is the aggregate of a specified percentage of claims or net premiums (computed amount), plus the total liabilities of the insurance fund.

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LIQUIDITY

An insurer's liquidity is measured by the degree to which it can meet its financial obligations by holding cash and other investments that are sound and liquid, or through operating cash flow. Adequate liquidity should be maintained to meet the insurer's unexpected cash needs without the untimely sale of investments that may result in substantial realized losses due to prevailing disadvantageous prices. Unexpected cash needs could stem from a sudden catastrophic loss or if a rein surer defaults on its obligations. ECRL's liquidity analysis encompasses the review of:

• Underwriting cash flow. Assess the company's premium inflow in relation to underwriting outgo i.e. claims payment, commission and management expenses.
• Total cash flow. Apart from underwriting cash flow, also takes into account investment flows, interest, tax and dividend payments. Positive cash flow, or a cash flow ratio > 100%, helps meet some liquidity needs and also provides for future investment earnings.
• Liquid assets/Technical Reserves. Benchmark: > 100%. ECRL defines liquid assets as cash and deposits and government securities and Bonds. Technical reserves consist of unearned premium reserves and Claims reserves (Net outstanding claims). The ratio indicates the company's ability to respond quickly to heavy cash calls.

RESERVES

When an insurer underwrites a risk, it needs to build up technical reserves for claimable events that have yet to occur. Such reserving however, eat into company profits, thus increasing the risk of bottom-line oriented management under-reserving. Technical reserves comprise unearned premiums and claims reserves. Claims reserves are made up of case provisioning for reported claims as well as losses that have been incurred but not reported (IBNR). The analyst should request for the actuarial report prepared by an independent actuary. The actual IBNR amount that the company sets aside should at least equal the amount estimated by the actuary, although conservative insurers have been found to exceed this.

Our analysis encompasses:

• Review of insurer's track record in establishing adequate reserves
• Reserving assumptions
• Speed at which negative trends (higher claims frequency and claim costs) are reflected in reserves
• Likelihood of reserves being "plundered" during down cycles
• Comparison of insurer's loss development trends relative to its peers
• Discounting of loss reserves. Loss reserves established now but payable in the future earn investment earnings in the interim period. The reserves are discounted by the amount of estimated investment earnings.

Two uncertainties exist here: (1) the level of investment income and (2) the ultimate cost of the loss.

Another way that management may try to reduce the amount of current reserves is to incorporate planned future enhancements (such as tightening claims control aimed at lowering claims costs) in its reserving assumptions. However, such improvements remain untested.

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Technical reserves/net premium - The ratio is an approximate indication of reserves adequacy for short to medium tail insurers. Benchmark: 1.0 - 1.25x. The net premium is a proxy for the level of exposure to loss carried by the insurer. An increase in reserves need not necessarily indicate reserve adequacy if the level of exposure increases by a higher proportion. Similarly, a reduction in reserves may not be indicative of a weakened reserves position if premiums have fallen by a greater degree. Technical reserves + Shareholders'

Funds/net premium. Some insurers may prefer to strengthen their technical reserves rather than declare taxable profits. Combining capital and reserves at the numerator facilitates comparison between two differently managed operations. An insurer with a weak capital base should be more conservative in setting reserves. Likewise, if technical reserves are found to be inadequate, the policyholder will look to capital to meet his claim. Benchmark: > 1.5x

CAPITALIZATION

Comment for ECRL: The areas highlighted yellow in this section may be deleted if risk-based capital (RBC) is being implemented or if other rating agencies are already assessing capital adequacy on the basis of a risk-based capital model.

The analyst evaluates an insurer's capital level relative to its underwriting and investment risk exposures. Capital, represented by its shareholders' funds, acts as a buffer against adverse developments.

Our assessment of capital adequacy begins with a review of the insurer's risk based capital. Risk-based capital provides a means of measuring the amount of capital appropriate for an insurer to support its operations in consideration of its size and risk profile. Accordingly, the degree of risk taken by the insurer becomes the primary determinant of its capital requirement. The adequacy of an insurer's actual capital is measured by a comparison to its risk-based capital as determined by regulatory requirements with adjustments made at the discretion of the analytical team. Risk-based capital standards discourage insurers from accepting risks on non-economic terms which is fundamental to an insurer's preservation of its capital. Capital charges are applied to the main categories of risks insurers face, i.e. asset risk, insurance risk and operating risk.

Asset risk charges address the quality of the insurer's investment portfolio, in particular credit and market risk exposures, with an aim to establish reasonable estimates of expected losses under stress scenarios. Credit exposures stem from invested assets (from fixed-income bonds and loans to deposits with financial institutions), reinsurance recoverables and deposits, and outstanding premiums, agent balances and other receivables due from other insurers or agents. Rating-sensitive charges apply to credit risks exposures. At the discretion of the analytical team, additional charges could be applied to these credit exposures to reflect higher default assumptions relative to that incorporated in the risk-based capital framework. The market risk capital charges are made against the market value of an insurer's assets for exposures to equity, interest rate, real estate and currency risks. Finally, asset concentration risk capital charges address individual counterparty concentrations or concentration of exposure to particular asset classes. Insurance risk is the risk of under-estimating liabilities from business already written and adverse claims while operating risk refers to the risk of losses arising from inadequate or failed internal processes, people and systems. The aggregate of capital charges for asset risk, insurance risk and operating risk establish the minimum capital requirements that insurers should meet.

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To derive a more complete picture of an insurer's capital adequacy, ECRL also looks at the composition of a company's capital structure. How much is equity? How much is debt? How much is preferred stock or other sorts of hybrid securities? Obviously the preference of rating agencies is for the more permanent types of capital, equity capital. The other types of capital are certainly acceptable in a company's capital structure, but with some limits. A capital structure with higher equity is almost always favoured more than one with less. We also look at the ability of a company to fund their capital needs internally. We consider not only the level of the insurer's capital adequacy today, but also the trends going forward. Is the insurer able to generate capital internally to continue to self-fund growth going forward? Is the insurer reliant on reinsurance to support their capital structure?

When an insurer underwrites a risk, the premium rate charged should reflect the extent of that risk. Having accepted the risk, the insurer needs to set up adequate technical reserves to cover for potential losses. However, any deficiency due to inadequate reserving or unexpected losses would have to be made good from the shareholders' funds. The operating leverage measures net premiums as a percentage of Shareholders' Funds and the benchmark ranges from 200% to 300%, depending on the size of the company and the insurer's business mix. Generally, small insurers have higher concentration exposures and less bargaining power to quote proper rates. Therefore, their capitalization needs to be relatively stronger. When measured against net premiums, the benchmark ratio should tend towards 200% for smaller and less diverse insurers, while larger insurers can operate with relatively leaner capitalization. The operating leverage also indicates the degree to which an insurer can grow premiums by before fresh capital injection is needed. Quality of capital is measured by the investment leverage ratio, which calculates the proportion of shareholders' funds held in real assets, i.e. equities and property. Over the long term, these assets outperform the inflation rate. But at a time of urgent liquidation, their values are subject to the volatility in these markets, which may lead to substantial capital erosion.

Bangladesh Insurance Act 2008 requires insurers to maintain a minimum solvency margin position to remain viable as an ongoing entity. Insurers must have a minimum paid up capital of BD Taka 400 million (USD 5.7 million) within the next five years of time, fully supported by admitted assets.

ECRL's analyst will also need to identify the insurer's expected short-medium term capital needs, e.g. are there acquisition plans in the pipeline; what is its premium growth target versus current operating leverage. Evaluate the insurer's access to the equities market through its own listing status or its publicly quoted parent. Other sources of financial flexibility include unutilized banking lines and the debt market through the issuance of commercial paper or long term debt. The likelihood of successfully tapping these markets depends on the company's track record and overall quality.

REINSURANCE UTILIZATION

Reinsurance usage is measured directly by the ratio Premium ceded/gross direct premiums. The inverse measurement, the retention ratio i.e. net premium/gross premium indicates the extent the insurer is retaining premium. Benchmark: > 50%. Issues to be considered:

• Over reliance on reinsurance. If more than half of gross premium are ceded out, the insurer may not effectively be making use of its underwriting expertise. The risk to the insurer's operation is if reinsures reduce their commitment or withdraw their support

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altogether in difficult times. The insurer also becomes more vulnerable to adverse developments in the reinsurance market such as escalation in reinsurance rates, reduction in capacity or changes to the terms and conditions. 1. The computed amount for general insurance business is the aggregate of a specified percentage of claims or net premiums 2. The margin of solvency is the computed amount plus the total liabilities in the insurance fund.

• Is the insurer retaining too much risk in its books and leaving itself exposed to catastrophe losses? "Catastrophe" has two distinct meanings. The more common reference is to a very large loss on a single policy or risk. The term also refers to uncertainty in the accumulation of retained losses, for instance, in the event a fire destroys several insured properties. Insurers normally protect their retained accounts against such losses through excess of loss treaty programmes covering the "catastrophe" layers.

• Reinsurer security. Relying on reinsurance is the exchange of underwriting risk for the credit risk of the reinsure. Will and can the reinsurer meet its obligations? The insurer could run into cash flow problems if it had to fund claims pending recovery from the reinsures or if a major reinsurer becomes insolvent or disputes coverage for claims. Review listing of reinsures and their current ratings by international rating agencies to assess credit quality. How does the insurer decide on an appropriate reinsurance programme and the level of retention for each class of business? Ascertain reasons for changes in retention limits over the past five years. Increases in retention limits normally result from a build up in the insurer's own capital strength or favorable claims experience in the specific class of business. What is the company's net retention level for each class of business with reference to its shareholders' funds? What are the company's selection criteria for reinsures (based on prompt claims payment, minimum rating criteria)? The company should not be reliant on just a few carriers.

Reinsurance recoverable/shareholders' funds- A high ratio may indicate collection problems or disputes with its reinsures.

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