RATING METHODOLOGY

Life Insurance

Alpha Credit Rating Limited

Outline:

ACRL's Claim Paying Ability (CPA) Rating is an opinion on the ability of life insurance companies to pay claims and policy-holder obligations in a timely manner. ACRL's rating is essentially comments on the financial strength of the insurance company as well as the ability and the strength of the promoting entities to support the insurance company and its products.

Typically a life insurance company would be providing policies under the following segments:

- **Protection -** including term insurance
- **Savings** - including participating, non-participating etc.

ACRL's methodology to rating life insurance companies involves a comprehensive analysis of Business risk, Industry Dynamics, Financial Performance and Corporate Governance.

A key element of ACRL's evaluation is the financial strength of the promoting entity and its ability to bring in capital to fund the life insurance company's growth and regulatory solvency requirements and support the latter's financial profile. The rating methodology is a combination of qualitative and quantitative analyses.

Business Risk:

ACRL assesses the business risk of an insurance company by looking into the degree of risk inherent in the company's business mix, company's market position.

A. **Market Position:** An Insurance Company can diversify their market exposure in different business lines. Hence, market share in each line of business and their key competitive advantages in different business are also analyzed. Diversity mitigates risks and ACRL therefore examines product as well as geographical diversity.

B. **Re-insurance:** Re-insurance arrangements are integral part of insurance risk management. It is the mechanism of diversify the underwriting risk among a number of re-insurer and increases the underwriting capacity of the insurer. It also imposes cap on the overall loss. ACRL assess the level of risk retained by the insurance company in accordance to their re-insurance strategy. Unusually high retention levels might signal inadequate re-insurance protection while low retention can affect the profitability.

C. **Investment Portfolio:** An insurance company deploys its fund in different assets. Most of the insurance companies keep major portion of their fund in fixed deposit with commercial banks and other financial institutions and ACRL observes the quality of the investment portfolio in terms of its composition, return and concentration.

Industry Dynamics:

Industry dynamics have a substantial impact on a life insurance company's operating position. Factors that affect the business prospects of life insurance companies are demographic characteristics, consumer behavior towards long-term savings and the overall regulatory framework. Industry and firm level competition have a major impact on pricing and profitability of a life insurance company. Though life insurance companies essentially provide mortality protection, the nature of products offered by them includes savings and investment related products, which put them in competition with other financial intermediaries such as asset management companies, pension funds and entities offering other long-term saving products. The competition among life insurance companies itself could lead to highly competitive pricing of life insurance policies, pressure to increase investment returns and higher selling costs.

Financial Performance:

ACRL's financial performance analysis includes the calculation of numerous financial ratios and concentration on other quantitative measurements. These areas are evaluated based on industry norms, specific ratings benchmarks, prior time periods and expectations developed by ACRL specific to the rated entity. Though the financial review is largely a quantitative exercise, the interpretation of the results and considering them into final rating includes significant elements of subjectivity and qualitative judgement.

A. **Capitalization:** A company's capital position is among the most important determinant of its financial position and reflects its ability to generate sustainable growth and absorb any volatility in underwriting and investment result. The capital levels are also important from the statutory solvency requirements specified by the regulator. Strong capitalization improves the company's ability to survive financial stress and informs it greater financial flexibility. Insurance companies are required to ensure adequate reserves to meet all future liabilities, which are determined on the basis of assumptions based on insurers' past experience, future expectations and with an appropriate margin for adverse deviations.

Since policy-holder surplus and capital are computed on the basis of actuarial valuation of liabilities, ACRL takes into consideration the actuarial assumptions and also evaluates the impact of the key variables such as interest rate changes on the company's capital and its sensitivity to changes in these variables. While ratios are an important part of the quantitative analysis in the rating process, ACRL evaluates these ratios and the capital levels of a life insurance company against the background of its business profile, its product mix, investment portfolio and asset quality and the overall management strategy. An insurance company provides a range of products such as term insurance, with-profit policies, defined benefit policies and various unit linked plans. The requirement of capital to support these products varies with term insurance requiring relatively higher capital allocation while products such as with-profit policies would require a lower allocation. Products such as term insurance products and guaranteed return products are also highly sensitive to changes in the interest rates, which have been used in the pricing of the insurance products.

B. **Profitability:** Core and sustained profitability of an insurance company is a key indicator of its competitiveness and operating efficiency. A life insurance company's profitability is a combination of its underwriting result and its investment income. ACRL evaluates both the underwriting result and the investment income. Since ACRL's ratings are forward looking, in our analysis of the company's profitability, we attempt to estimate the quality and sustainability of the future profitability under various scenarios based on the company's business fundamentals which include its product mix, business permit and its operating cost structure.

   Life insurers make losses in initial years because the income stream is spread over the policy term whereas the expenses relating to customer acquisition, infrastructure and marketing are front loaded. As the policy term progresses, life insurers recover various charges from policyholder, which compensate for the upfront expenses incurred by life insurance companies leading to higher net cash flows in the later years.

C. **Investment Performance and Risks:** An insurance company deploys policy-holder surpluses into investments and investment returns are also factored in the pricing of insurance. Within the investment guidelines framed by the Insurance Development and Regulatory Authority (IDRA), individual companies build their insurance portfolio to complement the insurance portfolio and liabilities and reflecting its own risk appetite and its shareholder expectations. A key challenge in investment management is to invest in better yielding long-term assets without compromising on the asset quality and the liquidity of the portfolio. ACRL evaluates the broad investment strategy of the company in relation to the nature of the insurance liabilities that it has, with an emphasis on asset quality, portfolio diversification and the liquidity of the investment portfolio.

   The key risks that the company's investments are exposed to are credit risk, market risk and liquidity risk. Given these risks, ACRL looks positively at a portfolio with a superior asset quality, and a portfolio diversified across various industries and asset classes; such as equities, Government securities, corporate debt, cash etc.

D. **Liquidity:** In insurance sectors, liquidity is particularly important. Good liquidity helps an insurance company to meet policyholder's obligations promptly. ACRL judge's liquidity based on the marketability of the investments. The manner in which the company values its assets on the balance sheet is also closely examined. A high degree of liquidity enables an insurer to meet the unexpected cash requirements without untimely sale of investments, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

E. **Solvency:** Adequacy of solvency margin forms the basic foundation for meeting policyholder obligations. All insurance companies are required to comply with solvency margin requirements. ACRL analyses the impact of changes in key variables on solvency margin to ascertain the strength of the insurer. Apart from the above, ACRL also assesses the current as well as potential underwriting capacity through an analysis of a firm's Operating Leverage.

Corporate Governance:

Corporate governance ensures the interest of the stakeholders as well as the society as a whole. ACRL observes the corporate governance practices of the insurance company as well as their deviation from best governance practices. The analysis not only concentrates on the Board practices but also include transparency in disclosure of relevant reliable financial and operational information, information on ownership and control.

A. **Ownership Pattern:** ACRL examines the ownership pattern in light with regulatory requirement and also in accordance to corporate governance practices. Concentration of shareholding of the sponsors, general public and institutions is assessed to find out the ownership construction and their support to the company.

B. **The Board of Directors:** The composition of the Board and its role are important consideration in ACRL's 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 ACRL's core concentration.

C. **Regulatory Compliance:** Insurance companies are regulated by Insurance Development and Regulatory Authority of Bangladesh (IDRA). ACRL reviews any lapses or inconsistencies with the regulatory requirement to find out whether the company is under any legal or pending cases that may jeopardize the operation in future.

D. **Management Information System:** ACRL examines the advancement in developing required IT infrastructure, data protection or disaster management system in light of operational risk mitigation.