Caribbean Information &
Credit Rating Services Limited

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METHODOLOGY FOR INSURANCE COMPANIES

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse insurance companies.

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CariCRIS offers two sets of products for insurance companies. The first is the regular credit rating, assigned for any borrowing programme of the insurance company. The second, and more common rating product in international markets, is the financial strength rating (FSR). Since insurance companies typically do not borrow (other than a few credit lines to meet any surge in claims or to fund any acquisition), the financial strength rating is a more popular product among insurance companies.

The financial strength rating indicates, in a relative scale vis-à-vis other rated / unrated insurance companies, the insurance company's ability to meet all its policyholder obligations (including legitimate claims) arising from its normal course of operations. The frame of reference can be national or regional, as in the case of normal credit ratings assigned by CariCRIS. The broad methodology adopted by CariCRIS for both these products is the same. However, in case of credit ratings, additional emphasis is laid on the extent of debt, its maturity profile as well as financial flexibility of the insurance company to meet maturing debt obligations.

CariCRIS' framework for rating insurance companies covers three broad sources of risk that these companies face viz. business risk, financial risk and management risk.

- **Business risk** analysis covers the business fundamentals of the insurance company, the characteristics of the industry in which it operates, growth prospects for the industry, its competitive market position in the industry, its underwriting and reinsurance policies, business mix among its various product lines and most importantly, the asset quality of its investment portfolio.
- **Management risk** analysis includes an evaluation of the company's management in terms of its competence in running its chosen lines of businesses, its risk appetite as well as management's integrity in its dealings with all its constituents.
- **Financial risk** analysis includes an assessment of the company's capitalisation levels adjusted for relevant risks, its past financial performance including key ratio analysis such as expense ratio, combined ratio, etc and its liquidity and financial flexibility.

It must be emphasized here that the above framework is the generalized version of the methodology that CariCRIS will use to analyze insurance companies. The analysis of entities in life and non-life insurance segments will be based on customized versions of this general methodology.

Business Risk

Industry Risk

The assessment of the industry risk captures the industry's characteristics such as its importance to the economy, its size, entry barriers, growth potential including present penetration levels, cyclicality, stability of underwriting performance of the industry and the regulatory policy. Regulatory issues would cover licensing requirements, pricing freedom, investment guidelines, accounting norms, solvency margins and the like, as well as extent of monitoring by the regulatory authorities.

Business Mix

The analysis would focus on a company's current business plan to understand its commitment to prudential underwriting standards. For life insurance companies, a good mix of life and annuity products can complement each other as these two provide a natural hedge of the risks of early death and of longevity. For non-life insurance companies, the business risk will be determined by the business mix comprising insurance for fire, marine, health, motor, aviation and miscellaneous segments, each of which carry a different risk profile.

Underwriting policy

Sound underwriting guidelines are pivotal to an insurance company's long term solvency. CariCRIS would attempt to understand the underwriting policies adopted by a company and its ability to manage risks associated with underwriting. Emphasis will be placed on the ability of the management to identify and focus on profitable underwriting, supported by value-added risk management services and service quality.

Pricing

CariCRIS would assess the pricing strategies adopted by the insurance company and the scientific actuarial computations backing these pricing computations. In life insurance business, the premium pricing is typically based on mortality rate, age at entry, profit sharing and other features such as health history and personal habits. Typically, the prediction of liabilities in life insurance can be fairly established based on historical data. On the other hand, a similar scientific backing for pricing non-life insurance products, backed by rigorous analysis of past data would mitigate business risks in this segment to a large extent.

Reinsurance

Reinsurance helps to diversity the underwriting risk among a pool of re-insurers and increases an insurance company's underwriting capacity. CariCRIS would assess the extent of risk retained by the company vis-à-vis the extent of risk passed on to re-insurers, by analyzing the reinsurance strategy of the company. While low levels of reinsurance might result in likelihood of large risks devolving on the company, a very high level of reinsurance may erode its profitability. CariCRIS would look for the optimum level of risk retention by the insurance company, in relation to its capitalization.

In the region like Caribbean, which is prone to natural disasters, reinsurance is very critical for both non-life and life insurance companies to limit the overall loss that could devolve on the primary insurer, arising from single events. CariCRIS would analyze the nature of the reinsurance contracts (excess of loss cover, catastrophe excess of loss cover, etc.), the credit profile of the re-insurers, past history of claims settlement as well as diversity of re-insurers engaged by the rated insurance company.

Market position

In this section, factors assessed include the market share of the insurance company in each line of its business, key competitive advantages enjoyed, strength of the distribution channel of the insurance company as well as geographical diversity of its business. The growth of the company in relation to the industry, its brand equity, its synergies, if any, with other operating companies within the same group as well as its strategic alliances (such as with a commercial bank to offer bancassurance products) would be analyzed in this section.

Asset quality

Prudent management of the investment portfolio is very critical in bolstering an insurance company's overall performance. Appropriate systems, judicious investment policies and internal controls are important components of fund management. The analysis would capture the company's investment strategy in terms of credit quality, capital appreciation, long term safety and easy liquidity. The investment portfolio's diversity across industries along with single risk concentration limits is important input in assessing the overall asset quality. It may be noted here that the very survival of a few insurance companies were jeopardized by poor quality of asset portfolio in global insurance markets, especially in US and Japan, during economic downturn witnessed few years back.

Technology and risk management

Technology to support delivery of products as well as to manage risks is very critical in the insurance industry. Appropriate systems help in better risk selection, pricing of products, monitoring legitimacy of claims as well quick settlement of claims, which enhances market position of the company.

Management Risk

The risk arising from management and its actions has the potential to override for better or for worse every other source of risk. CariCRIS assesses a company's management across three areas: competence, risk appetite and integrity.

- **Competence** examines experience and qualifications, ability to cope with crisis and external factors, skills in human resource management, past track record of performance of the management, stability in the senior management team, adequacy of planning and succession, etc.
- **Risk appetite** looks at management's propensity to risk selection and risk retention in its insurance business, its propensity to borrow and the purpose of such borrowing, its tendency to enter new markets and products, and its ability to manage the risks arising from such actions. When assessing risk appetite CariCRIS also studies the rated company's investment and financing policies.
- **Integrity** includes aspects such as transparency in group company transactions, transfer pricing, business ethics and the overall corporate governance systems and structures to ensure checks and balances and quality of disclosure.

Financial Risk

The main components of financial risk analysis include accounting policies, capitalisation, past financial performance as well as liquidity and financial flexibility of the insurance company.

Accounting policy

In most countries in the Caribbean region, regulations do not stipulate specific accounting policies, rendering comparison across insurance companies a difficult proposition. CariCRIS analyses the consistency of the accounting policies adopted by the insurance company, adequate disclosures in this regard (especially the income recognition norms) and other accounting policies in relation to international best practices.

Capitalisation

Capital provides the cushion to absorb any sudden adverse developments and hence assumes paramount importance in analysing an insurance company. The absolute level of capital, the adequacy of this capital in relation to the extent of underwriting (measured through net premium income / net worth and other similar ratios) and compliance to statutory capitalisation norms are analysed in detail. CariCRIS would also make a critical assessment of the willingness and ability of the current shareholders to infuse additional capital in case of any exigencies.

Financial performance

CariCRIS conducts a detailed analysis of the past financial performance of the insurance company, together with a comparison of the same with its peer group companies. Factors analysed include income levels and growth rates, expense ratios, claims ratios, combined ratios as well as capitalisation and liquidity ratios.

Liquidity and financial flexibility

This parameter takes into account an insurance company's resource strength and the liquidity support available to meet policyholder obligations. The liquidity position would also be a function of the management's policy of maintaining a treasury portfolio to meet liquidity demands. The primary sources of liquidity include underwriting cash flows, operating cash flows and investment portfolio liquidity. Besides, a line of credit facility from banks to meet short-term liquidity requirements (such as to settle immediate claims in case of a catastrophe) is an added source of comfort.

In addition to the above factors, assessing parent support is an important feature of CariCRIS' rating methodology. While assessing this support, CariCRIS would factor in three main aspects, viz.

- The economic rationale for support, including strategic importance of this company to the parent, ownership structure and economic incentive to support
- The moral obligation of the parent to support, assessed through commonality of board/management, management control, shared name, etc. and
- The credit quality of the parent company