# ICRA LANKA'S
# CLAIMS PAYING ABILITY RATINGS
# FOR INSURANCE COMPANIES

ICRA Lanka's Claims Paying Ability Ratings (CPRs) for insurance companies are opinions on their ability to honour policy-holder claims and obligations on time. In other words, a CPR is ICRA Lanka's opinion on the financial strength of the rated insurer, from a policy-holder's perspective. ICRA Lanka expects its CPRs to be an important input influencing the consumer's choice of insurance companies and products.

## ANALYTICAL FRAMEWORK

ICRA Lanka's CPRs reflect its opinion on the long-term relative risk associated with the rated insurers' ability to honour their commitment to policy-holders on time. The CPRs are, of necessity, forward-looking and predictive, given that they apply to liabilities that may pay out over long periods of time. Critical to the ICRA Lanka-CPR process is an analysis of an insurance company's business fundamentals and its competitive position within the industry. ICRA Lanka's CPRs are the culmination of an analytical process that examines the industry dynamics, the regulatory environment, and the business fundamentals of the insurance company concerned. The industry analysis part looks at the structure of competition within the insurance company's operating environment and its competitive position within that structure. The analysis of the company's business fundamentals, on the other hand, focuses primarily on franchise value, management, organisational structure/ownership, and underwriting and reinsurance strategies. The analysis of the insurance company's financial risk involves an assessment of key indicators, including profitability, liquidity, operating and financial leverage, capital adequacy, and asset/liability management.

## BUSINESS ANALYSIS

### Industry Analysis

The competition structure within each segment of the insurance industry is a significant determinant of the operating strength of companies in those segments. As for the insurance industry as a whole, the key factors influencing its financial strength include:

- Degree of concentration within the industry and within sectors
- Impact of competition on pricing strategies of individual participants.
- Barriers to entry

### Regulatory Environment

ICRA Lanka expects the domestic insurance industry, given its socio-economic importance, to remain under a fair amount of regulatory control in the coming years. Currently, the Sri Lankan insurance industry is governed by the Regulation of Insurance Industry Act, No 43 of 2000 and the subsequent amendments made by Regulation of Insurance Industry (Amendment) Act, No 27 of 2007 and Regulation of Insurance Industry (Amendment) Act, No 03 of 2011, and the rules and regulations that are gazette therefrom, which spell out the entry norms for new insurance ventures and also the norms for the valuation of assets and liabilities. ICRA Lanka evaluates the current regulatory environment, as well as the possible changes in regulations or taxation laws that could impact an insurer's competitive position or lead to a restructuring of the segments within the industry.

## Ownership, Management and Strategic Focus

The financial strength of an insurance company's parent is an important source of financial flexibility for an insurer, particularly in the start-up phase. A review of the insurer's parentage and all the subsidiaries and affiliates (if any) of the parent may be a simple or even a complex exercise. In either case, ICRA Lanka's CPR exercise also involves assessing the importance of the insurance company within the parent's group structure, the group's free cash flows, and the availability of these cash flows for meeting policy-holder claims, particularly during periods of stress. An evaluation of the parent is also important given that it may leverage itself to down-stream funds as capital to the insurance subsidiary, thus enhancing the subsidiary's capital adequacy. ICRA Lanka's CPRs have a strong linkage with the long-term debt rating of the parents concerned.

In evaluating the management of an insurance company, ICRA Lanka considers its track record in such areas as investments, distribution, and product innovation. The management's strategy, as reflected by the overall growth or new business development rate, also plays an important role in shaping ICRA Lanka's opinion on the financial strength of an insurer. Typically, ICRA Lanka's analysis entails extensive interactions with an insurer's management, and throughout the rating process, ICRA Lanka attempts to form an opinion on the management's quality and growth aspirations. This assessment is critical and necessarily subjective and helps in assessing the ability of the management to respond to challenges.

The areas of strategy reviewed during a CPR exercise include the insurer's long-term vision, risk-return appetite, attitude towards financial and operating leverage, strategies for raising capital, and view of shareholder value creation. Discussions with the insurer's management also serve to highlight its views on products and markets on which the company intends to focus, its expectations of success therein, and its expectations on the growth and profitability trends in the company's principal lines of business.

## Operating Strengths and Business Franchise

The assessment of an insurer's franchise value focuses on its competitive position within its marketplace, and other characteristics that can help it create enduring value. Specifically, ICRA Lanka assesses the quality of the insurer's products and distribution systems, its image and reputation. Moreover, ICRA Lanka examines whether the insurer has sustainable advantages in its key lines of business, and assesses its ability to utilise such advantages in new areas.

The method and mechanism using which an insurance company delivers its products, particularly for commodity lines of businesses, is another fundamental aspect of the company's business profile. For some insurers, distribution strategy may be a source of competitive advantage, while for others, the same may provide flexibility in pricing and management of business volumes. Whatever the strategy, ICRA Lanka views an insurer's control over its distribution system, as an important indicator of its competitive advantage within its line of business.

## Underwriting

The prices charged to customers are estimates of amounts necessary to cover costs, most of which will be incurred and paid in future. Consequently, an insurer's premium rate monitoring process, as well as its underwriting process, must be reviewed and evaluated. ICRA Lanka evaluates the different business segments within which the insurance company operates, first, by reviewing past underwriting results, and second, by reviewing current underwriting procedures that will determine future profitability levels. A key objective here is to analyse the risks inherent in the insurance company's business mix. Pricing sufficiency of the insurer would also be evaluated in terms of ability to design correct pricing on the basis of expected losses in the portfolio, which are a key determinant of underwriting and claim settlement risk.

## Reinsurance Strategy

Reinsurance plays an important role in reducing exposure to catastrophic risks and in enhancing an insurer's operating leverage. ICRA Lanka evaluates an insurer's use of reinsurance to determine the degree to which the company relies on it for leverage. Quality of reinsurance is a key factor in this analysis. ICRA Lanka tries to assess the structure of the insurer's key reinsurance programmes in relation to the probable maximum loss estimates and past catastrophe experience. Assessing the quality of reinsurance recoverables is also an important part of ICRA Lanka's analysis of asset quality. This typically involves identifying both reinsurers from which the company has the largest over dues and those to which it has significant exposures. A review of the credit-worthiness of these reinsurers is made by reference to their International Financial Strength Ratings and by considering prior payment experience.

## FINANCIAL ANALYSIS

### Capitalisation

Central to ICRA Lanka's assessment of insurance financial strength is its assessment of both the financial and operating leverage of the insurer. The purpose of this analysis is to form an opinion on the insurer's use of financial and operating leverage, and to determine how such practices affect its overall financial flexibility. ICRA Lanka assesses the operating leverage in terms of the business volume generated relative to the insurer's capital, and evaluates the financial leverage in terms of financial obligations relative to capital. The operating leverage would capture risks from adverse reserve development, pricing inadequacy and reinsurance credit exposure. A higher leverage may boost shareholder returns, but at the cost of policy-holder security. An adequate capitalisation protects an insurer's ability to withstand catastrophes, adverse changes in underwriting results and volatility in investment returns and the quantum of capital required is usually a function of an insurer's business mix, business volumes and quality of asset portfolio.

### Profitability

One of the most important factors in ICRA Lanka's CPR process is the profitability of the insurer. This, in turn, is a function of a number of factors, including: (1) market focus of the insurer; (2) competitive dynamics in each market segment; (3) operating costs; (4) underwriting record and outlook; and (5) investment strategy. ICRA Lanka assesses each of these factors to reach a conclusion on the insurer's expected long-run profitability, and on the risk of the actual results deviating from expectations. Besides, ICRA Lanka makes an evaluation of the product-wise underwriting profitability, which provides a good indication of the returns generated by the insurer's principal lines of business. Historical profitability trends also provide the background for subsequent discussions with the insurer's management on the outlook for profitability in the principal business segments. An important objective of this profitability analysis is to develop a view on the quality and sustainability of earnings, since these issues are key to the insurer's long-term solvency.

### Liquidity

ICRA Lanka's analysis of liquidity considers the sustainability of operating cash flows, the marketability and liquidity of the investment portfolio, and the availability of other sources of liquidity, such as lines of credit. Liquidity is evaluated in relation to potential demands on the insurer's available funds, including the payout pattern of loss reserves, and the extent to which the insurer is exposed to catastrophe risks.

### Investment Risk

ICRA Lanka evaluates an insurer's asset quality by reviewing its investment portfolio. In this exercise, ICRA Lanka considers the credit and interest rate risks relative to the nature and mix of the insurer's liabilities. Specifically, the degree of diversification and the liquidity of the portfolio are looked at. High concentration in one type of security raises concerns over market or credit risk, and the sustainability of returns. Eventually, ICRA Lanka's evaluation of the investment portfolio entails a review of how the portfolio as a whole may be expected to perform in future, considering the credit risk, market risk and interest rate risk involved. ICRA Lanka's analysis of an insurer's investments also involves an understanding of the insurer's investment goals and the regulatory constraints, which together influence the construction of the portfolio.

## Asset/Liability Management

Asset liability management assumes considerable significance where the assets and liabilities have widely different maturity profiles and liquidity characteristics. Insurance companies sell insurance contracts and invest the proceeds in primary securities (bonds, stocks, mortgages, etc.), with the allocation of the proceeds across different investment options being guided by the norms laid down by IBSL. ICRA Lanka's analysis of the asset liability management practices of an insurer primarily involves understanding the exposure profile (anticipated claims payment patterns) and assessing the degree to which the investment cash flows can service policy-holder demands.

## SUMMING UP

The rating process involves both quantitative and qualitative assessment of issues. We obtain and analyse company provided data as well as information available from public sources. The process is highly interactive involving significant discussion with management to get insights into its strategy and risk appetite. Consistent with our general approach to ratings, there exist no formulaic approach to arrive at the rating and the emphasis is on the qualitative assessment of issues over a mere quantitative approach.

### *ICRA Lanka's Long-Term Rating Scale*

AAA -The Highest claims paying ability assigned by ICRA Lanka. Indicates fundamentally strong position. Prospect of meeting policyholder obligations is the best.

AA - High claims paying ability assigned by ICRA Lanka. Risk factors are modest and may vary slightly. Prospect of meeting policyholder obligations is high and differs from AAA only marginally.

A -Adequate claims paying ability assigned by ICRA Lanka. Prospect of meeting policyholder obligations is adequate. The risk factors are more variable and greater in periods of economic stress and any adverse changes in business /economic circumstances as may be visualized, may alter the fundamental strength.

BBB -Moderate claims paying ability assigned by ICRA Lanka. The protective factors are below average and adverse changes in business /economic circumstances are likely to affect the prospect of meeting policyholder obligations.

BB - Inadequate claims paying ability assigned by ICRA Lanka. The protective factors fluctuate in case of changes in business /economic conditions and prospects of meeting policyholder obligations are more likely to be affected by such changes.

B -Weak claims paying ability assigned by ICRA Lanka. Risk factors indicate that policyholder obligations may not be met when due. Adverse changes in business /economic conditions could result in inability /unwillingness to service policyholder obligations.

C -Lowest claims paying ability assigned by ICRA Lanka. Indicates fundamentally poor position. Such companies may often be in default on policyholder obligations may be or are likely to be placed under supervision by insurance regulator.