RATING METHODOLOGY

Non-Life Insurance

Alpha Credit Rating Limited

Outline:

ACRL's Claims Paying Ability (CPA) rating is an opinion on an insurance company's financial strength and measures its ability to honor policy claims as per contractual commitments. The opinion is not specific to any particular insurance policy or contract. The rating methodology for general or non-life insurance companies entail assessing them on a stand-alone basis and the level of parent support they receive. On stand-alone basis, factors such as industry and business risks, the risk management systems, goals and strategies are analyzed apart from examining the financials. The total analysis is grouped into four sections: Financial Performance, Corporate Governance, Industry Risk and Business Profile.

1. **Financial Risk:** ACRL performs the financial risk assessment of an insurer by considering the following indicator:

   A. **Risk Underwritten:** Analysis of risks underwritten constitutes the key element in a CPA rating assessment and plays a vital role in the final outcome of the rating assigned. The efficacy of a company's underwriting strength is judged by its historical claims experience, degree of diversification in risks underwritten and the relative growth in business volumes. ACRL evaluates the pricing of insurance products, mix of tariffed and non-tariffed businesses. Each business segment of the insurer is analyzed in depth with an emphasis on understanding its unique competitive characteristics that would drive future earnings potential or cause deterioration in financial strength.

   B. **Asset Quality:** Claims Paying Ability of an insurer could be hampered by future losses on its investment portfolio. In respect of insurance entities, asset quality assumes a greater dimension as it influences not only the level of income but also has a direct bearing on the insurer's ability to provide instant liquidity in case of claim settlement.

   Insurance entities are susceptible to credit as well as market risk on their asset portfolio similar to banks. In this regard, ACRL analyses the quality and diversification of assets across various classes. As most of the asset deployment decisions are largely guided by certain regulatory constraints, ACRL reviews the insurer's level of adherence to regulatory norms. AlphaRating also measures the degree of success of the asset deployment strategy vis-à-vis the slated goals of maintaining a fair degree of liquidity, yield optimization and capital protection. ACRL broadly examines factors such as: portfolio diversification, credit quality of investments, and adequacy of provisioning and liquidity of the investment portfolio.

C. **Earnings:** Profitable operations are necessary for insurance companies to operate as a going concern. ACRL focuses on an insurer's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable profit margins. ACRL analyses the profitability of the underwriting and investment functions separately.

   i) **Underwriting Performance:** Underwriting profitability is influenced by the level of premium income, agency commission, staff costs and claims experience. AlphaRating studies premium growth, risk retention, loss ratio, expense ratio, combined ratio, investment ratio, operating ratio to gauge the underwriting performance of an insurer.

   ii) **Investment Performance:** Investment income is largely a function of the investment strategy followed by the company. The behavior of the securities market and interest rate movements also influence the returns on the investment portfolio. ACRL examines the market risk and its probable impact on earnings to assess the performance of investment operations in terms of investment yield.

D. **Liquidity:** Good liquidity helps an insurance company to meet policyholder's obligations promptly. An insurer'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 or through operating cash flows. 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. ACRL examines current liquidity and Operating Cash Flow to weigh the liquidity condition.

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.

F. **Reserve Policy:** ACRL studies the reserving policy of the insurer and would examine the claims experience vis-a-vis the reserves created. The shortfall in reserves, if any, would then be compared with the insurer's net worth.

G. **Capital Adequacy:** IDRA has prescribed a minimum paid-up capital of BDT 400.00 million for non-life insurance companies. To assess the company's financial health, ACRL's analyses also covers solvency margin.

2. **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.

3. **Industry Risk:** The overall insurance industry is analyzed based on its importance to the economy, its size and growth potential, entry barriers, the stability of underwriting performance as well as the policies governing the sector. Investment guidelines, accounting norms and solvency margins are examined.

4. **Business Risk:** AlphaRating assesses the business profile 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:** Non-life 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.