

RATING CRITERIA FOR LIFE INSURANCE COMPANIES

WASO Credit Rating Company Limited has been assigned Financial Ratings to insurance companies since February 2012. The ratings assess an insurance company's ability to meet policyholder obligations. The rating methodology of WASO Credit Rating Company Limited for life insurance companies comprises two parts: a stand-alone assessment and an assessment of parent support. The stand-alone assessment factors in industry and business risks, the risk management systems instituted in the company, its management's stated goals and strategies, its projected business plan and financial analysis. Parental support is especially crucial for start-up insurance ventures given the need to recapitalize such companies till they break even and start generating profits.

STAND-ALONE ASSESSMENT

Industry Risk

The analysis capture the industry's characteristics such as its importance to the economy, size, entry barriers, growth potential (present penetration levels and future growth prospects), cyclicity, stability of underwriting performance and the regularity policy. Regulatory issues cover licensing requirements, pricing freedom, investment guidelines, accounting norms and solvency margins.

Business Risk

The business risk analysis includes factors specifically influencing a particular company. These include:

Business Mix: The analysis focuses on a company's projected business plan to understand its commitment to prudential underwriting standards.

A life insurance company can offer both life and annuity products. Life insurance offers support to the families of those who die early, whereas annuities provide a stable source of income during the post-retirement phase. Nevertheless, life products can combine the features of an annuity; annuity products can also be designed to provide life cover.

From a risk perspective the early death of a life insurance policyholder entails meeting obligations at an earlier date, which could result in a loss to the insurance company. On the other hand, the prolonged life of an annuitant entails paying more than the estimated obligations to the annuitant (which can also result in a loss to the insurance company). Therefore, the business mix has to be an optimal combination of life policies and annuities to hedge both these risks of early death and of longevity. Like business diversity, product diversity is also important.

Pricing: As life products are a combination of savings and life cover, the interest rate in the economy plays a critical role in pricing these products. Besides, pricing is dependent on the mortality rate, age at entry, product features (with profit and without profit policies) and other features such as occupational risk, family and health history

and personal habits. For annuity products, pricing is on the basis of the annuitant's longevity or survival rate.

Underwriting policy: sound underwriting guidelines are pivotal to the long-term solvency of an insurance company. Here, the emphasis would be to understand company's underwriting policies and its ability to manage risks associated with underwriting. For life insurance companies, payments to policyholders include claims due to death, surrender of the policy or its maturity. Unlike in the case of non-life insurance, in life insurance, estimation of liabilities can be established relatively easily as the risk of death can be estimated with some degree of accuracy based on historical mortality rates. The analysis attempts to capture the mortality table adopted by the life insurer and estimate the actual claims (mortality) faced by the company.

Selection of the life assured is a critical element in the underwriting process. Life insurance companies need to put in place systems to mitigate adverse selection. Besides, other factors such as occupational profile, male-female ratio and the insured portfolio's age group also have an impact on a company's overall underwriting performance.

Distribution Channel: A life insurance is targeted at individuals; a wide and strong retail distribution network is required to generate business volumes. Besides, individuals need to protect themselves by way of life covers. This is an educative process and converting prospective customers into effective insured clients has its own gestation period. The analysis capture put in place by an insurance company. A wide distribution channel is critical to sustaining growth and optimizing distribution expenses.

The profile of agents in terms of their qualifications, age groups and experience is also important. For start-up companies, motivation and training are critical as retaining agents is an important aspect of the life insurance business. This has implications on the agents' productivity, the policy lapses and surrenders, which, in turn, have an impact on marketing costs. Productivity parameters for agents include first year premium income generated and sum insured per agent.

Reinsurance Policy: Reinsurance facilitates the diversification of an insurance company's underwriting risk amongst a pool of reinsures besides increasing the company's underwriting capacity. WASO Credit rating Company Limited assesses the level of risk retained by the insurance company by studying its reinsurance strategies, the reinsurance programs it has entered, the extent of reinsurance and the financial strength and credit profiles of the reinsurance companies.

Asset Management: Prudent management of the investment portfolio is critical to bolstering an insurance company's overall performance. Appropriate systems, judicious investment policies and internal controls are important components of funds management.

Life insurance is a long-term product. Premia received from policyholders is invested in short, medium and long-term assets. Investment inflows (interest and principal on maturity) are utilized to meet policyholder obligation. It is imperative that the investment strategy focuses on asset quality, containing asset-liability mismatches and

maximizing yield on investments. In fact, some of the factors that have led to the poor performance of insurance companies in the global markets are a mismatch of asset and liabilities, poor quality of asset portfolios and low returns on investments.

The analysis captures 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 and companies along with single risk concentration limits are important inputs in determining the company's overall asset quality.

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 the better risk selection, pricing of products, monitoring legitimacy of claims and quick settlement of claims.

Financial Risk

For new entrants in the insurance sector, parameters such as start-up capital, future capital infusion plans in line with business requirements, compliance of solvency ratio as stipulated by the Insurance Regulatory Development Authority (IRDA) and adequacy of solvency margin are assessed. The timeframe by which the start-up will break even, the liquidity plan put in place to meet policyholder obligations and the accounting policies adopted are also critically examined.

Capitalization: IRDA has prescribed a minimum start-up capital of RS.1 billion for life insurance companies. To ensure the company's safety and financial health, IRDA has prescribed required solvency margins (RSM), which need to be maintained by all life insurance companies. In addition to regulatory compliance, the analysis takes into account the adequacy of the solvency margin projected an insurance company.

Financial performance: All new players are expected to report a weak financial performance in the initial years. The high level of initial establishment expenditure, franchise building costs and distribution costs in setting up an agency network will strain the companies' finance during the start-up phase. Under such circumstances, WASO Credit rating Company Limited discusses with the management and promoters their willingness and ability to infuse additional capital till the start-up breaks even and begins generating profits.

Actuarial valuation is an integral and key component in the life insurance business. The valuation process involves discounting the future inflows and outflows based on an appropriate discount rate, thereby resulting in a valuation profit or loss. WASO Credit rating Company Limited analyses the assumptions behind the actuarial valuation and undertakes a sensitivity analysis to assess the company's financial position under adverse conditions.

Liquidity and Financial Flexibility: This parameter takes into account an insurance company's resource strength and liquidity support available to meet policyholder obligations. The liquidity positions is also a function of the management's policy of maintaining a treasury portfolio to meet liquidity include underwriting cash flows, operating cash flows and investment portfolio liquidity. A line of credit facility from banks to meet short-term liquidity requirements is an added source of comfort. Capital commitment from promoters is another important source of financial flexibility as

insurance companies are expected to have adequate financial flexibility to meet unforeseen contingencies.

Surrender, lapse and cancellation of policies can influence a life insurance company's liquidity position. WASO Credit rating Company Limited analysis focuses on the mechanism put in place by life insurance companies to cope with such eventualities.

Parent Support

Assessing parent support is an important feature of WASO Credit rating Company Limited rating methodology. In this case, WASO Credit rating Company Limited factors in the economic rationale and moral obligations of the parent towards the insurance venture.

The economic rationale captures the strategic importance of the venture, the economic incentive for the parent to support the venture and current and prospective ownership structures. An assessment of the parent's moral obligation to support the venture captures factors such as management control and the management's stated posture towards the start-up. WASO Credit rating Company Limited analyses the promoter's stated posture to support the start-up company on an ongoing basis and under distress scenarios. The parent's financial strength also plays a pivotal role in assessing the overall support that it would extend to the insurance venture.

The key rating drivers thus including the start-up capital, business strategy and future capital infusion plans, the promoters' experience in insurance and asset management businesses and the parental support that would be provided to the venture.

Insurance Ratings

WASO Credit rating Company Limited in Bangladesh launches "Financial Strength Rating" for insurance companies in February 2012. The financial strength rating assigned by WASO Credit rating Company Limited is a comment on the insurance company's ability to meet policyholder obligations.

A financial strength rating is critical for life insurance companies given the target segment and the long-term tenor of contracts. A life insurance product is offered to individuals and the tenor of a life policy typically ranges from 10 to 20 Years. Therefore, to gain the confidence and trust of prospective customers, it becomes imperative for life insurance companies to obtain a financial strength rating which is an informed and objective opinion. Besides, a financial strength rating may offer other benefits such as facilitating agents and brokers in their distribution efforts and enhancing the standing with the regulator.