ICRA LANKA

ICRA LANKA'S RATINGS FOR LIFE INSURANCE COMPANIES

Insurance Financial Strength Rating (IFSR) is ICRA Lanka's opinion on the financial strength of the rated insurer and its ability to honour policy-holder claims and obligations on time. ICRA Lanka's IFSRs is a comprehensive analytical process that examines the industry dynamics, the regulatory environment, and the business fundamentals of the life insurance company concerned, its competitive position within the industry, and its financial strength. ICRA Lanka's IFSRs are essentially forward looking and attempt to assess the company's ability to withstand stress and meet policyholder liabilities.

ICRA Lanka expects its IFSRs to be an important input influencing the consumer's choice of insurance companies and products.

ANALYTICAL FRAMEWORK

ICRA Lanka's methodology to rating life insurance companies involves a comprehensive analysis of industry dynamics, the regulatory environment, the company's franchise and competitive position, and its financial position. A key element of ICRA Lanka'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 and includes an interactive process with management to understand and assess its strategy and key aspects of its business, which qualitatively drive its operating position and financial policy. ICRA Lanka's IFSRs are essentially forward looking and attempt to assess the company's ability to withstand stress and meet policyholder liabilities.

The note below outlines ICRA Lanka's methodology for rating domestic life insurance companies and covers the assessment of the business and financial risk profile of a life insurance company and an evaluation of its ownership and management quality.

Business Risk Profile

Industry dynamics: Industry dynamics have a significant impact on a life insurance company's operating position and the product, market and pricing strategies available to a company and eventually have a bearing on the industry's and company's long term core profitability. Some of the factors that affect the business prospects for life insurance companies are demographic characteristics, consumer behaviour towards long-term savings and retirement planning, the social security systems [or the lack of it], and the overall regulatory framework. Industry and firm level competition have a major impact on pricing and profitability.

Though life insurance companies essentially provide mortality protection, the nature of products offered by them encompass 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. One direct implication of the competition has been the increasing complexity of insurance products as life insurance companies add various features and flexibilities into them. 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. Regulatory policies and fiscal

incentives such as tax benefits for insurance products also have an impact on the funds being channeled to life insurance companies. ICRA Lanka evaluates the regulatory framework and the impact of evolving regulatory policy on the business prospects for the sector in general and the company in particular.

Business Franchise and Operating Position: The franchise that a life insurance company has is critical in determining its long-term business profile and eventually its core profitability. A company's franchise may arise out of its brand building efforts, its distribution strategy, and its ability to provide a basket of products to meet a range and varying needs of its consumers. A favourable cost of operation is also a source of competitive advantage as it can drive the company's competitiveness in the insurance markets and its market share.

A strong business franchise would eventually lead to the company's strong market position, and its ability to generate growth, and hence would be a key determinant of core profitability and internal capital generation. Even as capital requirements are high in the initial phases of the life insurance companies, growth is an imperative not only to achieve market share, but also to achieve the requisite risk dispersion for insurance claims to be in line with expected claims.

ICRA Lanka uses various indicators to evaluate a life insurance company's operating position. These include

- market position and share,
- its distribution strength and cost,
- efficiency and quality of agency force and distribution channels; persistency ratio
- underwriting and pricing experience,
- product mix, and ability to design, launch and manage new products
- performance across various insurance product categories,
- investment performance
- Operating efficiency and overall cost of operation.

A well-diversified life insurance product portfolio and a mix of income from insurance/risk products and fees make for a strong operating profile and impart stability to the quality of the company's revenue and income stream. Comparison of the above indicators with peer group is a key part of the operating performance evaluation. Also products need to be evaluated for risk mitigation and pricing adequacy, especially for return guarantee schemes.

One of the critical factors affecting long term performance of life insurance companies is persistency. Healthy levels of persistency not only indicate higher renewal premiums but also a strong consumer franchise. The longer a policy stays in force, the more likely an insurer is to recover costs and make profit over the life of the contract. Companies with lower persistency levels relative to industry are viewed negatively as it may indicate customer dissatisfaction and low prospects of repeat business.

ICRA Lanka also notes that a favourable business franchise and operating position, are more likely to sustain the strategic interest of the promoting companies, and ensure ownership continuity and steady capital infusion.

Reinsurance Strategy: Reinsurance is an important aspect of a life insurance company's risk mitigation programme. It is an effective means of protecting the insurer's capital and making capital available for future growth, especially in the initial phases when the demands on the capital are high and risk dispersion yet to reach optimum levels. The reinsurance requirements of a life insurance company would depend on the product mix with term insurance products especially for policies with large values of sum assured, typically requiring a larger reinsurance support. ICRA Lanka's evaluation of a life insurance company's reinsurance programme would essentially focus on its reinsurance philosophy, its reinsurance partners, their credit quality and the re-insurers' track record in meeting obligations towards the life insurance Company in the past.

Financial Risk Profile

The main parameters that ICRA Lanka uses in evaluating a company's financial position are its capitalisation, underwriting profitability and investment performance, and asset liability management and liquidity. In its financial analysis of life insurance companies, ICRA Lanka uses various quantitative indicators and ratios. However, ICRA Lanka's financial and ratio analysis is not an exercise in isolation. A strong and a sustained financial profile is eventually an outcome of sustained operating and competitive strengths. Thus ICRA Lanka's financial analysis aims to evaluate how the financial position reflects or supports the business risk profile of the Life Insurance Company.

Capitalisation: 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 stipulated by the regulator. Strong capitalisation improves the company's ability to withstand financial stress and imparts it greater financial flexibility. Two key ratios that ICRA Lanka looks for evaluating capitalisation are the operating leverage which is a ratio of the level of business that a company writes in relation to net worth, and financial leverage which is the level of policy holder surplus as a percentage of net worth. A higher leverage does help to generate higher returns to the shareholder but could undermine protection available to policyholder.

Insurance companies are required to ensure that reserves are adequate 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. The adequacy of such provisions needs to be evaluated carefully, especially in the light of recent regulatory changes in charge structure on products, which may alter the operating economics of distribution channels, lead to higher surrenders, slowdown new business and result in cost overruns.

Since policyholder surplus and capital are computed on the basis of actuarial valuation of liabilities, ICRA Lanka 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, ICRA Lanka evaluates these ratios and the capital levels of a life insurance company against the backdrop 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 assured (guaranteed) return products are also highly sensitive to changes in the interest rates, which have been used in the pricing of the insurance products.

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. ICRA Lanka evaluates both the underwriting result and the investment income and also looks at core profitability before capital gains and dividends paid out to policyholders. Capital gains can often be volatile and may depend on temporary developments and not really reflect the company's ability to generate returns on its investments. Since ICRA Lanka'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 franchise 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 pertaining 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/ cash outflow incurred by life insurance companies leading to higher net cash flows in the later years. From an accounting perspective, the commission and business acquisition expenses are charged up-front to the P&L account in the year they are incurred thereby leading to accounting losses in initial years.

Historical profitability analysis helps to throw light on these aspects and can form a basis of discussion with management on past trends and their strategy in the future for sustaining or improving operating profitability.

Investment Performance and Risks: An insurance company deploys policyholder surpluses into investments, and investment returns are also factored in the pricing of insurance. Within the investment guidelines framed by the Insurance Board of Sri Lanka (IBSL), individual companies construct 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. ICRA Lanka 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. ICRA Lanka also takes into consideration the historical performance of the investment division in order to get insights into how the division has been able to meet the investment objectives of the company.

The key risks that the company's investments are exposed to are credit risk, market risk and the liquidity risk. Given the long term nature of the insurance business' liability profile and oftentimes the limited availability of assets/investments of similar maturities, the value of company's assets and liabilities can be significantly and differently affected by interest rate changes. Corporate debt also has significant credit risks driven by general economic conditions, regulatory policies and changing competitive pressures across industries. Equities too are exposed to significant market risks driven by the above factors besides volatile capital flows and a host of other issues. Given these risks, ICRA Lanka looks positively at a portfolio with a superior asset quality, and a portfolio diversified across various industries and assetclasses/instruments (such as equities, government securities, corporate debt, cash etc.)

Asset Liability Management and Liquidity: Asset Liability management are procedures and systems adopted by the company to ensure that its assets and cash flows meet the maturing near term and long term liabilities. A life insurance company writes insurance contracts for long periods and these contracts also provide for surrender, loans and flexible premium options. The pricing of these contracts are also based on expected interest rates and inflation levels over these periods. Some key features in the evaluation of the investment portfolio include asset liability management, liquidity and the impact of changes in the economic scenario and macroeconomic variables such as inflation and interest rates.

The increasing complexity and features being built into life insurance products has increased the importance of the asset liability management process in the life insurance business, and product design, investment

management and asset liability management have become increasingly integrated. Thus in order to prevent an adverse development in the asset liability position due to options provided in their policies, insurance companies are increasingly building controls such as surrender costs, higher incentives for longevity of policies and so on.

The focus of ICRA Lanka’s asset liability and liquidity analysis is to evaluate management’s strategy to mitigate the impact on cash flows and profitability while honouring maturing liabilities, and the likely change in the expected maturity of liabilities due to changes in the economic environment and actuarial assumptions. ICRA Lanka computes the ratio of liquid assets to the surrender value of the insurance liabilities to estimate its liquidity. ICRA Lanka also evaluates near term liquidity by assessing the maturity of near term liabilities, which can be met through maturing assets and expected cash flow from existing written business.

Management Quality and Ownership

Management Quality: Evaluation of management quality is a critical factor in ICRA Lanka’s rating process. Among the various features that ICRA Lanka factors in evaluating management quality are management vision and strategy, the experience and performance of its key management team, management’s appetite for risk, and its risk management and control systems and processes. ICRA Lanka believes that sound operational procedures and controls are important in the life insurance business and would be key to efficient customer service. ICRA Lanka also evaluates the organisational framework and the cost structure. An area of significant focus would be the accounting and reserving practices of the company. ICRA Lanka would look positively at a prudent and conservative approach in the making of actuarial assumptions and the robustness of the company’s capital to likely changes in these assumptions. The past operating performance of the company would also be a parameter in the evaluation of management capabilities.

Ownership and Financial Strength of Parent: ICRA Lanka’s rating methodology for life insurance companies especially the ones in the private sector would factor in significantly the financial strength of the promoters and their strategic interest in the business. The life insurance business in its initial phases creates a substantial amount of strain on insurer’s capital due to the business start up costs, high initial marketing costs, and the reserve creation for meeting future policyholder benefits. Thus a Life Insurance company needs regular infusion of capital to maintain the solvency requirements stipulated by the regulatory agencies and for meeting future business growth. ICRA Lanka evaluates the financial strength of the promoting entity, its sources of operating cash flows and commitments, its allocation of funds for the life insurance business, and the strategic significance of the life insurance business to it. ICRA Lanka’s IFSRs for new life insurers or those in their initial and formative years are likely to be closely linked to the financial strength and credit quality of the parent company.

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.

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