LIFE INSURANCE RATING - METHODOLOGY

Insurer Financial Strength (IFS) rating of a life insurance company assesses the financial strength and its capacity to meet obligations to policyholders on a timely basis. This rating is forward-looking opinion while the liabilities it covers belong necessarily to the future period. Therefore, it is utmost critical that the financial indicators which are depicting a certain risk profile of the insurer remain stable over the medium term. Consequently, the approach that NCR has employed is a blend of qualitative and quantitative data. The quantification helps in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. NCR uses the key parameters under qualitative and quantitative assessment is listed below to assess the quality of operations of a life insurance company and the services offered by it. Each parameter is assessed individually; these assessments are then aggregated to arrive at the final rating.

1.0 QUALITATIVE ASSESSMENT

1.1 Governance: NCR considers the independence and effectiveness of the board of directors to be an essential element of a robust governance framework. The board's oversight of such related party transactions that may lead to conflicts of interest is evaluated. Board oversight of the audit function is also assessed for understanding the safeguard of integrity of an entity's financial reporting. NCR also assesses the timeliness, quality and comprehensiveness of the information package which goes to the board members prior to each meeting. This enables the members to prepare themselves with reference to the agenda points and participate effectively in the meeting. The committee structure of the board is evaluated in the context of the business needs of the company. NCR believes that an effective board should delegate significant important tasks to each committee for an in-depth and productive deliberation. This would enable the board to evaluate refined representations of the committees and focus only on significant critical issues.

1.2 Management: NCR's assessment of management focuses on company strategy, risk tolerance and funding policies of the management. NCR reviews management's track record in terms of its ability to create a healthy business mix, maintain operating efficiency and strengthen market position. Company goals are evaluated to determine if management has an aggressive style dedicated to rapid growth that maximizes near-term earnings or a conservative style geared toward optimizing cash flow over the long term. Although a judgment on the quality of management is subjective, financial performance over time provides a more objective measure.

1.3 Risk Management Framework: The evaluation of the quality of policies, procedures and invariable adherence to those policies and procedures remain pivotal in the assessment of the control environment. Segregation of duties and occupancy of the all important positions would provide comfort as to the minimization of operational risk. NCR, therefore, assesses the quality of the I.T. infrastructure and the breadth and depth of activities performed by this division. Herein, analysis of the integration of the company's operations into technology would be pivotal. One significant advantage of technology is the timely, precise and accurate MIS. The analysis of MIS being generated by the technology and its use by the department heads and the top management would underpin the comparative advantage (or disadvantage) that the company would have on a relative scale.

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1.4 Sponsors' Support: If the shareholder of the life insurer operator is a corporate entity, NCR traces its steps to reach the individual (group of individuals) who stands behind the corporate entity (or the group). This identification involves knowledge of the history of the sponsors, their expertise, business ideology and other business interests. After identification of the sponsors and their business philosophy, NCR assesses how the life insurer operator fits into that philosophy. Is the life insurer operator core to the sponsor, a strategic investment or just an investment? This would help in forming an opinion regarding what kind of support the sponsors would be providing to the company.

NCR classifies sponsors' support into two types: a) ongoing support b) extraordinary support. The ongoing support may come in multiple forms, for instance, technology, branding, and marketing. The ongoing support, being the continuing feature, would provide comfort in any of the relevant sections described above. The extraordinary support denotes the support provided in unusual circumstances and may take the form of : i) liquidity injections during crisis, ii) subordinated loans to ease cash flow pressure, iii) recapitalizations to improve capital structure, iv) arrangement of a solvency rescue package through other market participants. NCR assesses the willingness and ability of the sponsors to provide extraordinary support and incorporate the benefit in the IFS rating of the life insurer operator. The benefit reflects the extent of support and the legal mechanism in place to provide the support.

2.0 QUANITATIVE ASSESSMENT

A. BUSINESS RISK

2.1 Industry Dynamics: The process for IFS rating of the life insurer's operators builds on NCR's understanding of the life industry dynamics. This understanding, following an in-depth research approach, is documented. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to see whether the local players have established effective mitigates against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, NCR takes a view on industry's significance in the economic environment of the country, its attractiveness to entrepreneurs, barriers to entry, and the power of suppliers and customers.

2.2 Market Position: Market position reflects the standing of the life insurer in the related market. The stronger this standing states the stronger the company's ability to sustain pressures on its business volumes and profit margins. This standing takes support from various factors including a) market size, b) growth trend, and c) brand equity.

2.2.1 Market Size: Market size represents the company's penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a strong correlation between an insurer's absolute and relative size and its market position and brand value. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. The quality of risk management guidelines and their invariable implementation is the key to ensuring sustainability in the market position. Aggressive expansion at the expense of underwriting quality is considered a major negative.

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2.2.2 Growth Trend: While evaluating the size, NCR looks at the rate of growth. Growth is important as it ensures that the insurer continues to have the ability to meet (or beat) the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach and improve the quality of service. To lag the industry's growth trend means to remain short on all these avenues, putting pressure on the market position.

2.2.3 Brand Equity: An insurer's brand reflects the strength of its image and reputation in the market, recognition and perception of its products by the distributors and ultimate clients. The brand also commands the clients' loyalty, ability of the insurer to cross-sell, while bringing down its cost of distribution. Typically, higher and sustainable price trends would highlight the strength of the brand and/or franchise value. This would help the company to strengthen its market share, ensure comparative growth rate and enjoy healthy margins.

2.3 Persistency: One of the measures to gauge the brand loyalty, market perception and reputation of the life insurer is to see the retention rate. Life insurance is generally believed to be a long tailed business unlike general insurance; therefore continuation of the premium is fundamental to life insurance business. An insurer incurs a lot of upfront cost for the acquisition of the business in view of its long term retention. Persistency is important from many perspectives. While persistency implies profitability, it reflects that the client is satisfied with the product and the product provider on an overall basis. This, in turn, is a booster for further generation of business. While first year persistency is a healthy sign, the second year and beyond persistency provides assurance as to the sustainability of premium inflow to the insurer. NCR considers those insurers having excellent ability which are capable of replicating largely the same premium in the succeeding years as in the first year.

2.4 Diversification: Diversification encompasses many aspects which govern the business model of an insurer. The rationale for this is that diversification enhances the ability of the insurer to meet challenges, both present and upcoming. The lack of diversification gives rise to concentration risk, reflecting vulnerability of the insurer to few elements. Concentration is considered a major negative because it limits the insurer's ability to ensure sustainability in its business let alone expand it. At the same time, it enhances the risk of disruption in the operations if the area of concentration goes wrong. This entails diversification in the distribution channels, premium mix, product line, client base and geographic spread.

2.5 Distribution: Distribution is the way by which an insurer reaches out to its clients. The strength (or weakness) of distribution directly affects the business prospects of the insurer and hence its ability to repay policyholders. Diversity of distribution channels, the extent of their contribution towards the premium base and insurer's ability to exercise control on these channels are some of the important things to evaluate. For rating purpose, it is worthy only to look at the critical channels. Are they in full control of the insurer? What kind of influence the insurer has over these channels? If they are run by third party, the historical relationship with them and how much attractive is the insurer to the channel owners or vice versa? Is the relationship exclusive or non-exclusive? If non-exclusive, what are other players who share in this channel, and the extent of competition with them? Business acquisition cost, which is an important consideration from profitability perspective, is also an offshoot of distribution framework of the insurer.

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2.6 Premium Mix: The premium comes to the insurer in various forms and shapes, mainly determined by the type of policy being bought by the client. The policies may be classified from purely risk protection to purely saving schemes. The former mainly specifies the risk that these are covering while the latter represent investments much similar to the products of asset management companies. In between both extremes, there is a range of products which blend characteristics of both types, such as whole life, universal life and endowment. Life insurance policies may also be classified according to the type of clients these serve: individual or group.

Individual policies, sold to individuals, are viewed more favorably because these represent relatively higher stability and persistency. Group policies, covering a group of people, are usually term based and normally reflect a higher risk of claims and cessation. With reference to term, life insurance policies may be classified into permanent or temporary. Permanent policies remain effective until the death of the policyholder or the occurrence of the insured event. Endowment, apart from the risk coverage during the active period of the policy, has a cash value and therefore provides sum-assured to the policy holder at the maturity of the policy. Policyholders have the option to surrender such policies prior to the maturity and avail the cash value at that time. The insurer remains exposed to the risk of occurrence of the insured event prior to maturity till the time the cash values of these policies are short of related sum assured. Permanent policies may have a single premium mechanism, whereby premium comes to the insurer in one go or represent a regular stream of premium to the company over the life of the policy. While the regular premium policies provide the advantage of stable source of revenue, the single premium policies cushion the risk of high payouts due to occurrence of insured event prior to the accumulation of cash values. While evaluating the premium mix, although a high value is placed on individual regular premium policies, those insurers are viewed more favorably which develop an optimum mix of different type of policies, supplementing each other due to the related attached advantages.

2.7 Profitability: The operations of a life insurer operator are a combination of two activities: underwriting and investments. Underwriting represents the premium for the risk coverage of the policy holder. This premium is also invested; yet the objective is to enable the insurer to meet the claims when they arise. The policy holder *per se* does not have a right to the returns that the insurer generates on this investment. Investments are the amounts which have been given to the insurer to invest and make returns. The accumulated balance of these investments, minus the insurer fee or commission depending upon the product, essentially belongs to the policyholder. The clarity as to these functions is important as the insurer is exposed to different risks with reference to each type of activity. While the underwriting exposes the insurer to the risk of occurrence of insured event, terminating into a payout of claim, the investments are only a matter of fee/commission income and spread of entry/exit depending upon the product profile. NCR views those insurers favorably which are self-sustainable in the underwriting business; given investments and related returns already belong to the policy holders. This implies that insurers making calls on the shareholders' fund for capital contribution would indicate either lack of economies of scale or pending improvement in the underwriting practices.

The surplus or deficit in the revenue account is impacted by various line items, which warrant independent analysis, including claims and management expenses. Another critical item is actuarial valuation, which underlie the insurer's estimation as to the liabilities arising in the future. NCR assesses the quality of the actuarial framework deployed by the insurer. For an in-house actuarial function, the educational and experience profile of the human resource, quality and extent of actuarial working and reports and the challenge which these are put to are some of the essential elements for the assessment in this regard. For external

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actuaries, the reputation and franchise value of the firm come into play. The objective is to form an opinion that the liabilities are not underestimated to achieve performance related milestones.

2.8 Investment Performance: The business model of insurance involves management of insurance float; the premium received in anticipation of probable claims in the future. This float is invested to make returns. The efficiency of the infrastructure deployed to manage investments can only be gauged through evaluating the comparability of returns and consistency therein. For premium related to pure investments, the insurer is further exposed to the risk of redemption if competitive performance is not delivered. This is judged through the movement of unit price, as investments normally represent unit linked policies. Herein the return is the cumulative gain whether realized or unrealized on the average investment portfolio maintained during the period.

B. FINANCIAL RISK

2.9 Claims Efficiency: The underlying risk that the insurer financial strength rating covers is the risk of claims not being met by the insurer. Timely and accurate repayment of claims carries utmost importance in the rating methodology. Claims efficiency represents the pattern in which claims are being settled by the life insurer operator. NCR believes that insurers having higher rating would be carrying lower amount of outstanding claims in general circumstances (adjusted for one-off events). While this ensures ultimate satisfaction of the policy holder, it denotes spread-out of cash outflows over a number of period instead of their accumulation to a single year.

2.10 Re-insurance: The re-insurance is the risk coverage obtained by the insurer against insurance claims. Herein, business philosophy of the insurer with reference to risk retention comes into play. A high quantum of risk retention means higher exposure to claims though profits would be higher as well. If a large amount of risk is retained by the insurer, it should be duly supported by its risk absorption capacity. Alternatively, higher cession means that there is greater reliance on the reinsurer. Therefore, the credit profile of the reinsurer becomes important. NCR evaluates rating of the re-insurer, their experience in the respective market, their historical relationship with the insurer, treaty terms, and their respective share in the reinsurance pool.

2.11 Liquidity: The liquidity profile states the company's ability to pay the outstanding claims. An effective structure deployed in the operational framework would ensure that a significant portion of claims is being met through the operational cash flows. The investment book may represent investment in the listed securities in addition to cash and cash equivalents. Listed securities are adjusted for that scrip's wherein volumes are insignificant. NCR believes that the mix of the investment book is critical in assessing the overall comfort which may be placed on the liquidity of the company. While exposure towards the equity market may be determined by the investment philosophy of the company, NCR relates the extent of exposure with the overall risk profile of the insurer and hence its IFS rating. The third shield of protection is the strategic investment book, if any.

2.12 Asset Quality: The quality of the investment book is assessed to form an opinion that the investments are not concentrated in high risk avenues. Apart from the equity investments, which are otherwise viewed in the context of the overall risk appetite of the insurer, the remaining investments are evaluated from the perspective of the credit profile of the investee. The fixed income funds are evaluated against their stability; bonds against their respective credit rating or the rating of the issuer; in case of no rating, these are taken to belong to non-

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investment grade. Bank placements have the underlying rating of the bank. For exposure to government debt, the sovereign is treated as the prime borrower. The weighted average rating of the book is computed to align it with the overall risk profile of the insurer.

2.13 Current Ratio: NCR assesses the quality of receivables and inter-corporate balances to judge whether any pending impairment exists, which could potentially reduces the company's risk absorption capacity. This indicates the management's strategy of meeting its working capital requirements. NCR strives to form an understanding of the underlying reasons and relate it with the business model of the company. Normally, the tilt toward asset side would represent a comfortable picture yet, at the same time, it could indicate that the fund stuck in the receivables may be subject to impairment. For this, an analysis of the aging and scrutiny of the major clients becomes imperative.

2.14 Capital Adequacy: Capital is pivotal for organizational sustainability, growth drive and as a last cushion against adverse circumstances. Capital, represented through the shareholder's fund, is essentially the support function in the life insurance business. NCR evaluates the capital in the context of the company's business model. This understanding stems from the realization that a company following a high risk and high growth business strategy would have an entirely different capital requirement as against a company following a conservative business model. While computing and analyzing the capital, NCR also considers the regulatory regime applicable to the life insurer operators, and their internal models, if any, for judging the adequacy of capital.

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