# MARC RATING METHODOLOGY

# GENERAL INSURANCE FINANCIAL STRENGTH

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## INTRODUCTION

MARC's insurance financial strength ratings assess the financial security characteristics of an insurance company with respect to its ability to meet its obligations to policyholders in accordance with the terms of their insurance contracts.

When rating insurance companies, MARC's analysts consider macroeconomic factors, industry dynamics (including regulatory issues), and individual company performance. The analyst examines how economic factors affect the company's growth opportunities and financial condition. In-depth analyses are then made of the insurer's business, management and corporate strategy, operating and underwriting performance, investment, liquidity, capitalisation, reserves and reinsurance arrangements. MARC's rating methodology incorporates the combined inputs of quantitative financial analyses as well as qualitative assessments based on interactive discussions with senior management.

Domestic general insurance players consist of 19 general insurers and four composite insurers as of end-June 2017. Personal business lines (motor, medical and health, and personal accident insurance/takaful), which have smaller exposures per policy and less complex policy features, are the main products of general insurers. The motor insurance and takaful segment, for example, represents 43.4% of the general insurance and takaful business. Its significant share is mainly

attributed to the captive market of motor insurance due to the mandatory requirement for insurance cover to be taken by motor vehicle owners in respect of any liability for death or injury caused to third parties.

The dominant share of personal business lines resulted in a relatively high insurance business retention level with about 90.4% of insurance premiums and takaful contributions underwritten domestically being retained in the country in 2016. Domestic capacity to underwrite and retain larger and more complex risks, however, remains underdeveloped resulting in such risks being largely insured abroad. This is more pronounced in the marine, aviation, liabilities, performance bonds and energy segments of business. Underwriting marine, aviation and transit insurance (MAT) business requires specialist underwriting expertise which is lacking in Malaysia and it is an area subject to international competition.

## BUSINESS REVIEW

This section defines the key characteristics of organisational structure and activity which constitute the company's competitive strengths and weaknesses. The assessment focuses on the company's current and potential revenue-generating capabilities. However, the negative aspects that could hurt future results must also be highlighted – threat from existing competition, threat from new entrants particularly from the liberalisation of the industry to foreign players, and threat of rival products (from the banking and unit trust sectors).

Market positioning of the insurer and market share by major product lines- The analyst must understand how this market share was obtained –the market share would be more sustainable if obtained through the company's competitive advantage rather than rate cutting.

MARC considers the company's five-year growth trend against the industry's (measured by premiums written). If rapid growth was recorded, understand the reasons and determine whether it is sustainable. Moderate growth that is sustainable is viewed more positively than rapid growth that is not sustainable. If revenues are declining, evaluate their impact on the insurer's ongoing financial strength.

Business mix – This is an evaluation of the products or classes of insurance marketed and underwritten by the company. The analyst would also analyse the distribution of net premiums written into the respective classes of insurance and perform a five-year trend analysis, highlighting reasons for major changes to product segmentation. Does the company have a strategic and sustainable competitive advantage in a particular product line? How well diversified is the product mix?

Underwriting standards and claims management – The financial performance of the company is dependent on the quality of the business accepted, and, therefore, the analyst needs to review the insurer's

underwriting guidelines. Proper claims control will alleviate fraudulent claims, but the insurer must also ensure that claims are paid promptly and fairly. Claims chiseling will result in an unfavourable reputation and a loss of market share, but consistent overpaying of claims will weaken its financial position.

The mainstay of the general insurance industry's distribution network is the agency system. The analyst should check on heavy dependence on a few agencies to provide the bulk of the business. Insurers with bank group affinities can source a sizeable portion of their business through bancassurance products. Internet insurance (which is open to all insurers) also serves as a cost-effective alternative distribution channel.

Other competitive strengths include expense efficiencies, strong distribution capabilities, quality of service, specialised underwriting skills and a franchise value/name recognition. For a firm's long-term success, it is crucial that it differentiates itself from its competitors. Firms without a sustainable competitive advantage are viewed least favourably.

## MANAGEMENT AND CORPORATE STRATEGY

This area consists of a review of the strategic positioning of the company, its organisational structure and how it fits the firm's strategy, operational effectiveness and financial risk tolerance.

Our review should ask what management's goals are and how its strategy is developed. Is its primary objective to grow market share, grow in absolute terms or to maintain a minimum level of profitability? Does management have a coherent system of planning, monitoring benchmarks and reviewing strategies? How has the compensation system been designed to support its strategy? What is management's record of converting plans into action and how successful has it been at achieving past targets? How are these plans communicated to lower level management?

Meetings with senior management can reveal the company's readiness to embrace challenges/threats. What are the company's plans with respect to (a) increasing efficiency and productivity, (b) enhancing technical skills in areas such as underwriting, information systems and asset management, (c) product innovation, and (d) improving service quality? An assessment is made of management's ability to meet new products from competitors, as well as its own ability to bring innovative new products to the market place. How much resources are put into research and development of new products and markets?

Operational effectiveness is an assessment of a company's ability to execute its strategy. What is management's track record in exercising strong control over operations; what are the internal audit controls used? Bank Negara Malaysia (BNM) continually emphasises on the improvement of handling general insurance claims, particularly in the fair treatment of

claimants and increasing efficiency in the processing and settlement of insurance claims. The analyst gets an idea of the insurer's position in this area of claims handling, as well as the number of complaints from policyholders and the nature of complaints. How long does it take for a claim to be settled from the time a claim report is made?

The analyst should understand management's financial risk tolerance and philosophy on reserving practices, use of reinsurance, assumption of external debt, allocation of invested assets and measures of capital adequacy. Management may have a higher risk tolerance in one area which needs to be tempered in other areas for an overall viable business strategy. For instance, a higher risk underwriting portfolio should be counterbalanced by a lower risk investment strategy or stronger capitalisation.

Other organisational considerations include: frequent and significant changes in senior management, over-reliance on certain individuals, high staff turnover, unrealistic forecasts which put management under undue pressure, rapid expansion of the business beyond the administrative capabilities of management, and a high incidence of official public complaints.

## OPERATING AND UNDERWRITING PERFORMANCE

The analyst should evaluate the insurer's operating performance trend over a five-year period. Operating performance is an indicator of its ability to grow the capital base and support business growth. Also, poor underwriting and underpricing of contracts commonly a cause of insurer distress. Stability in operating performance is viewed more favourably than a strong performance in a particular year, if that performance is not sustainable.

Operating statistics for the past five years, for each class of business, are analysed for any significant difference in:

- Gross premiums written- Comprises direct premiums as well as reinsurance acceptances.
- Net premiums written- The amount of premiums retained by the company after reinsurance.
- Underwriting expenses- Net claims incurred, agency commissions and management expenses. Net claims incurred is net claims paid after accounting for changes in provision for outstanding claims during the year.
- Total investment income.

Underwriting profits are generated when premiums exceed claims and administrative expenses. An insurer's underwriting performance is measured by the **combined ratio** which is the aggregate of the loss ratio and the expense ratio. The loss ratio is the ratio of net claims incurred to earned premium income. The loss ratio data for each class of business is

compared with the industry loss ratio for the same class of business. The expense ratio is the ratio of the sum of agents' commission and management expenses to net premiums written. A low expense ratio can be a competitive pricing tool to an insurer. A combined ratio below 100% produces an underwriting profit, and one above 100% denotes an underwriting loss. A ratio of 100% indicates a breakeven performance before taking investment income into account.

Loss ratios typically escalate during an economic slowdown due to higher crime-related claims i.e. burglary, arson, car thefts, and declining premium volumes as policyholders cut back on sums assured. Exchange rate fluctuations may also have an impact on claims cost of imported replacement parts. Due to the long-tailed nature of certain claims, unprofitable underwriting and underwriting losses can be obscured by under- reserving. There is evidence to support the view that insurer failures are more prevalent at the bottom of the underwriting cycle rather than at the top of the cycle when most insurers are profitable. High ratios can occur because of underpricing and/or because of unexpected high claims.

When analysing trends in the loss ratios, MARC seeks to understand the reasons for aberrations. How does its loss experience compare with its peer average? This could point towards certain competitive advantages or weaknesses. An insurer which has been consistently recording lower loss ratios compared to its peers may have implemented very stringent claims control procedures. However, the downside risk is that if its policyholders perceive that claims are not fully and fairly settled, they may switch insurers upon renewal.

Different business segments have different level of loss ratio. The motor insurance segment experienced significant loss ratio exceeding 100% due to a significant number of claims exceeding premiums. The setting of premiums was based on general criteria set by the government. Nonetheless, the government has taken steps to gradually liberalise the industry. The progressive liberalisation of motor and fire tariff rates will take place over a three-year period to allow for orderly market adjustments. The industry moved into the first phase of liberalisation on July 1, 2016, where new motor and fire products were offered at market-based prices while existing motor products under the tariff continued to be available to the public at prevailing tariff rates. In the second phase, which commenced on July 1, 2017, tariffs were removed for all existing motor products except compulsory motor third-party products where tariff rates will be gradually adjusted. Further liberalisation of the tariff for motor third-party products will be reviewed in 2019, taking into account market developments observed under Phases I and II. The market liberalisation is expected to improve general insurance companies' profitability, particularly in the motor insurance business, which has been pressured by a high number of claims.

The insurer's underwriting profits are supplemented by investment income in the form of interest, dividends and capital gains on the insurance fund's assets.
The **operating ratio,** which is the combined ratio less investment income ratio (investment income divided by earned premium income) measures overall profitability (in underwriting and investing) of the insurer.

## INVESTMENTS

Premiums of an insurer that are not allocated to payments of claims, agents' commissions or management expenses are invested in various types of assets to earn investment income.

The major investment classes are:

- Cash and deposits
- Public securities (government and Cagamas securities)- Low risk assets.
- Private Debt Securities (PDS)- Periodic coupon payments, but certainty of these payments and ultimate repayment of the principal depends on the credit risk of the issuer, which its rating attempts to represent. PDS which are sold prior to their maturity will either realise a gain or loss, depending on the interest rate environment and rating changes.
- Ordinary shares- Cash flow stems from the periodic payments of dividends, which can be variable, and the market value of shares.
- Loans- Periodic interest payment and principal repayment. Deviations from expected cash flow can be caused by default by the borrower.
- Property- Cash flow is derived from rental income, and can be interrupted by tenant defaults and termination of tenancy.

The investment portfolio is analysed for credit risk, market risk, liquidity and diversification. The better the liquidity, diversification and quality of assets, the more certain the value to be realised upon their sale, and the lesser the likelihood of default. Credit risk is analysed by looking at the performance of its loans portfolio (current/delinquent), credit rating and rating downgrades of its PDS portfolio. Market risk is the risk of changes in asset valuation due to changes in market conditions i.e. stock market, interest rates and property prices. Liabilities of general insurers are shorter tail in nature, thus a higher liquidity level is needed of its invested funds. MARC defines liquid assets as cash, deposits and public securities. Investment diversification should be weighed by asset class, industry sector, and individual investments. Prudent exposure limits to individual borrowers and sectors should be set and monitored to avoid concentration of risk.

MARC's investment analyses include:

- The investment team's qualifications and experience
- Investment objectives in relation to rate of return, investment selection and portfolio diversification. An insurer's level of risk tolerance is determined by the degree of variability in investment returns that is acceptable to management.
- Historical investment performance is evaluated to determine how well the company's investment strategies are executed.
- The investment manager's stated objective in relation to risk should be compared with the past and present investment strategy in areas of portfolio composition, asset quality and concentration levels.
- Investment philosophy – the basis of stock and PDS selection and loan credit underwriting criteria.
- Portfolio monitoring and timeliness of portfolio adjustment when actual performance deviates from targets, or expected future returns are unacceptable.
- Portfolio management techniques/risk management – use of financial derivatives to hedge its investment portfolio e.g. options and futures to hedge stock market exposures.

MARC looks to the investment yields, defined as investment income divided by average invested assets, to assess how well management in investing the written premiums.

Investment returns and their volatility reflect the insurer's investment risk appetite, the interest rate environment and stock market conditions. In some instances, it may also reflect a need to investment in property or equities to provide an inflation hedge for long-tailed business. The yield on invested assets measures investment income before realised capital gains/losses and tends to exhibit less volatility compared to total investment return, which includes capital gains/losses in its computation. General insurers have to maintain a more liquid investment portfolio, but there is the corresponding trade-off between liquidity and investment returns.

## LIQUIDITY

An insurer's liquidity is measured by the degree to which it can meet its financial obligations by holding cash and other investments that are sound and liquid, or through operating cash flow. Adequate liquidity should be maintained to meet the insurer's unexpected cash needs without the untimely sale of investments that may result in substantial realised losses due to prevailing disadvantageous prices. Unexpected cash needs could stem from a sudden catastrophic loss or if a reinsurer defaults on its obligations.

MARC's liquidity analysis encompasses the review of:

- Underwriting cash flow- the company's premium inflow is assessed in relation to underwriting outgo i.e. claims payment, commission and management expenses.

- Total cash flow- Apart from underwriting cash flow, also takes into account investment flows, interest, tax and dividend payments. Positive cash flow, or a cash flow ratio exceeding 100% indicates an ability to meet liquidity needs and generate future investment earnings.
- Liquid assets/Technical Reserves- Generally, liquid assets are those that can be converted into cash quickly and without realizing capital losses. Technical reserves consist of unearned premium reserves and claims reserves (net outstanding claims). The lower the number, the higher the risk to policyholders in terms of the company's ability to respond to its obligation to policyholders promptly. Benchmark: > 100%.

## RESERVES

When an insurer underwrites a risk, it needs to build up technical reserves for claimable events that have yet to occur. Such reserving however, eats into company profits, thus increasing the risk of bottom-line oriented management under-reserving. Technical reserves comprise unearned premiums and claims reserves. Claims reserves are made up of case provisioning for reported claims as well as losses that have been incurred but not reported (IBNR). The analyst should request for the actuarial report prepared by an independent actuary. The actual IBNR amount that the company sets aside should at least equal the amount estimated by the actuary, although conservative insurers have been found to exceed this.

Our analysis encompasses:

- Review of insurer's track record in establishing adequate reserves
- Reserving assumptions
- Speed at which negative trends (higher claims frequency and claim costs) are reflected in reserves
- Likelihood of reserves being "plundered" during down cycles
- Comparison of insurer's loss development trends relative to its peers
- Discounting of loss reserves- Loss reserves established now but payable in the future earn investment earnings in the interim period. The reserves are discounted by the amount of estimated investment earnings. Two uncertainties exist here: (1) the level of investment income and (2) the ultimate cost of the loss.

Another way that management may try to reduce the amount of current reserves is to incorporate planned future enhancements (such as tightening claims control aimed at lowering claims costs) in its reserving assumptions. However, such improvements remain untested.

Technical reserves/net premiums- The ratio is an approximate indication of reserves adequacy for short to medium tail insurers. The net premiums are a proxy for the level of exposure to loss carried by the insurer. An increase in reserves need not necessarily indicate reserve adequacy if the level of

exposure increases by a higher proportion. Similarly, a reduction in reserves may not be indicative of a weakened reserves position if premiums have fallen by a greater degree. Benchmark: 1.0 - 1.25x.

Technical reserves + shareholders' funds/net premiums- Some insurers may prefer to strengthen their technical reserves rather than declare taxable profits. Combining capital and reserves at the numerator facilitates comparison between two differently managed operations. An insurer with a weak capital base should be more conservative in setting reserves. Likewise, if technical reserves are found to be inadequate, the policyholder will look to capital to meet his claim. Benchmark: > 1.5x.

## CAPITALISATION

An insurer's capital level is evaluated relative to its underwriting and investment risk exposures. Capital, represented by its shareholders' funds, acts as a buffer against adverse developments. When an insurer underwrites a risk, the premium rate charged should reflect the extent of that risk. Having accepted the risk, the insurer needs to set up adequate technical reserves to cover for potential losses. However, any deficiency due to inadequate reserving or unexpected losses would have to be made good from the shareholders' funds.

The **operating leverage** measures net premiums as a percentage of shareholders' funds and the benchmark ranges from 200% to 300%, depending on the size of the company and the insurer's business mix. Generally, small insurers have higher concentration exposures and less bargaining power to quote proper rates. Therefore, their capitalisation needs to be relatively stronger. When measured against net premiums, the benchmark ratio should lean towards 200% for smaller and less diverse insurers, while larger insurers can operate with relatively leaner capitalisation. The operating leverage also indicates the degree to which an insurer can grow premiums by before fresh capital injection is needed.

Quality of capital is measured by the **investment leverage** ratio, which calculates the proportion of shareholders' funds held in real assets, i.e. equities and property. Over the long term, these assets outperform the inflation rate. However, at a time of urgent liquidation, their values are subject to the volatility in these markets, which may lead to substantial capital erosion.

Licensed insurers are subject to BNM's Risk-Based Capital (RBC) Framework, which sets out the requirements to determine the adequacy of the available capital to support the required capital. The capital adequacy ratio (CAR) is calculated by dividing the total available capital to the total required capital. BNM has set a supervisory target capital level of 130%. A licensed insurer whose CAR breaches the supervisory target capital level will face stricter supervisory action, which may include business restrictions and restructuring measures. In addition, licensed insurers are also required to set

an individual target capital level, which must be higher than the supervisory target capital level. Breaching the individual target capital level will attract increasing level of supervisory attention.

Most insurers have little borrowing requirement as their cash flows are usually positive, and temporary imbalances can be addressed by their liquid investments. However, if faced with an extraordinary large claim and the insurer has to pay claims before recovering from the reinsurers, it may have to liquidate its investments and risk upsetting its investment structure, or it can tap external funds.

MARC identifies the insurer's expected short-medium term capital needs, e.g. are there acquisition plans in the pipeline; what is its premium growth target versus current operating leverage. Evaluate the insurer's access to the equities market through its own listing status or its publicly quoted parent. Other sources of financial flexibility include unutilised banking lines and the debt market through the issuance of commercial papers or long-term debt. The likelihood of successfully tapping these markets depends on the company's track record and overall quality.

## REINSURANCE UTILISATION

Reinsurance usage is measured directly by the ratio of premiums ceded/gross direct premiums. The inverse measurement, the **retention ratio** i.e. net premiums/gross premiums indicates the extent the insurer is retaining premium. Benchmark: > 50%.

Issues to be considered:

- Over-reliance on reinsurance- If more than half of gross premiums are ceded out, this raises questions as to the quality of the business, the insurer's underwriting expertise in respect of the ceded business as well as reinsurance counterparty risk. The risk to the insurer's operation is if reinsurers reduce their commitment or withdraw their support altogether in difficult times. The insurer also becomes more vulnerable to adverse developments in the reinsurance market such as escalation in reinsurance rates or a reduction in capacity or changes to the terms and conditions.

- Is the insurer retaining too much risk in its books and leaving itself exposed to catastrophe losses? "Catastrophe" has two distinct meanings. The more common reference is to a very large loss on a single policy or risk. The term also refers to uncertainty in the accumulation of retained losses, for instance, in the event a fire destroys several insured properties. Insurers normally protect their retained accounts against such losses through excess of loss treaty programmes covering the "catastrophe" layers.

- Reinsurer security- Relying on reinsurance is the exchange of underwriting risk for the credit risk of the reinsurer. Will and can the reinsurer meet its obligations? The insurer could run into cash flow

problems if it had to fund claims pending recovery from the reinsurers, or if a major reinsurer becomes insolvent or disputes coverage for claims. MARC reviews the approved reinsurer list, maximum exposure, limitations, their credit strength as indicated by their IFS ratings and reinsurance counterparty credit risk mitigation.

How does the insurer decide on an appropriate reinsurance programme and the level of retention for each class of business? Ascertain reasons for changes in retention limits over the past five years. Increases in retention limits normally result from a build up in the insurer's own capital strength or favourable claims experience in the specific class of business. What is the company's net retention level for each class of business with reference to its shareholders' funds? What are the company's selection criteria for reinsurers (based on prompt claims payment, minimum rating criteria)? The company should not be reliant on just a few carriers.

A high ratio of reinsurance recoverable to shareholders funds may indicate collection problems caused by weakening financial strength on the part of the reinsurers or disputed claims. Of rating significance will be the cash flow implications of the reinsurance collection backlog and the reinsurer's exposure to uncollectable reinsurance.

## RATING SYMBOLS & DEFINITIONS
## INSURER FINANCIAL STRENGTH RATINGS

### SECURE RANGE

**AAA** An institution rated AAA has an exceptionally strong capacity to meet its financial commitments and exhibits a high degree of resilience to adverse developments in the economy, and in business and other external conditions. These institutions typically possess a strong balance sheet and superior earnings record.

**AA** Insurance companies rated AA possess a very strong ability to meet their policyholder obligations. Their overall risk profile, while low, is not quite as favourable as for insurance companies in the highest rating category.

**A** Insurance companies rated A possess strong ability to meet their policyholder obligations but are somewhat more susceptible to adverse changes in economic and underwriting conditions than companies in higher-rated categories.

**BBB** Insurance companies rated BBB possess an adequate ability to meet their policyholder obligations. However, adverse changes in economic and underwriting conditions over time could affect their claims-paying ability.

### VULNERABLE RANGE

**BB** Insurance companies rated BB exhibit some weaknesses in their operating profile and/or financial condition. Currently able to meet their policyholder obligations, but claims-paying ability is regarded as marginal and cannot be assured over a long period of time. Such companies are vulnerable to adverse changes in economic and underwriting conditions.

**B** Insurance companies rated B exhibit fundamental weaknesses in their operating profile and/or financial condition. Currently able to meet their policyholder obligations, but claims-paying ability is regarded as weak. Such companies have limited capacity to withstand adverse changes in economic and underwriting conditions.

**C** Insurance companies rated C possess a very weak ability to meet their policyholder obligations. The continued capacity of these companies to meet their policyholder obligations is poor and highly dependent on favourable economic and underwriting conditions.

**D** Insurance companies rated D possess an inadequate ability to meet their policyholder obligations. Such companies require periodic external support or regulatory intervention, without which their continued viability is in doubt. The rating indicates that a default may have already occurred, or there is a high likelihood of default on their policyholder obligations.

**Note**: Ratings from AA to B may be modified by a plus (+) or minus (-) suffix to show its relative standing within the major rating categories.

### RATING OUTLOOK

MARC's Rating Outlook assesses the potential direction of the entity's rating over the intermediate term (typically over a one- to two-year period). The Rating Outlook may either be:

**POSITIVE** which indicates that a rating may be raised;
**NEGATIVE** which indicates that a rating may be lowered;
**STABLE** which indicates that a rating is likely to remain unchanged; or
**DEVELOPING** which indicates that a rating may be raised, lowered or remain unchanged.

MARC has refined its methodology for assessing General Insurance Financial Strength Rating. This methodology partly amends and supersedes MARC's "Rating Approach to General Insurance Financial Strength Rating" published in 2006. The revised methodology should be read in conjunction with MARC's "Non-financial Corporates" methodology which is available on MARC's website at www.marc.com.my.

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