

## Sector assessment

Prudential Ratings assesses a number of factors to determine the insurance sector's credit strength. Key assessment factors are broadly categorised into regulatory framework, industry structure and industry performance and financial position.

## Regulatory framework

Prudential Ratings looks at the strengths and weaknesses of regulatory statutes and instruments governing market conduct of participants, rigor and sufficiency of prudential requirements, demonstration of regulatory intervention, including an assessment of the quality of implementation and enforcement of applicable statutes and regulations.

Markets founded on sound legislation aimed at protecting policyholders' interests, fostering professionalism and good governance, and encouraging the use of industry best risk management tools and practices are likely to nurture a credit positive environment for industry participants. In this respect, Prudential Ratings gives credit to markets with sound and embedded solvency assessments (such as risk-based) and pro-liquidity and solvency regulations such as cash and carry. Furthermore, markets that have and observe initiatives such as treat policyholders' fairly, enforces sound corporate governance structures and upholds the use of actuaries and generation of annual valuation and financial condition reports are positively viewed. Furthermore, markets that enforce minimum premium rates regulations (aimed at forestalling price undercutting) and caps on commission rates and operating expenses are also considered favourably given their contribution to industry profitability. While Prudential Ratings value the existence of these legislations, more emphasis is placed on their successful implementation, which will in turn result in sound credit protection metrics for the industry.

## Industry structure

Monopolistic and oligopolistic industry structures, due to their price-setting and collusive behaviour capabilities are likely to be more profitable than other forms of market structures. In as much as these structures are known for their overpricing abilities, the capacity they build through realisation of abnormal profits is credit positive. Associated with these market structures is the existence of very high barriers to entry, which may be in the form of either regulatory or natural barriers. Monopolistic and oligopolistic structures are quite common in nationalised and liberalised markets with history of nationalisation.



On the other hand, competitive markets, while they are known for offering policyholders competitive rates, and a variety of products and service delivery, are often associated with the problem undercutting especially when minimum rates are not applicable or are not fully enforced and when the industry is experiencing stagnation. This will likely lead to increased underwriting risk (the risk that premiums charged may not be sufficient to cover the cost of providing insurance) and a reduction in industry profitability (should there be no offsetting sources of revenue such investment income), reduced liquidity and limited capital build. Accordingly, policyholders' interests will be at risk of not being honoured should the insured events materialise. That said, Prudential Ratings assesses industry structure based on concentration assessment (using the Herfindahl Hirschman Index) and factor in other qualifying attributes, such as the presence or absence of price undercutting practices.

### Industry performance and financial position

Prudential Ratings assesses industry performance from the perspective of industry premium growth, penetration rate, and earnings strength and quality while focusing on market liquidity and capitalisation when evaluating financial position.

Industries experiencing positive real premium growth that filters through bottom-line performance as a result of realisation of scale efficiencies are viewed favourably from a credit standpoint. In the same vein, insurance markets enduring increasing penetration rates (or those with matured penetration rates) stand to benefit from scale efficiencies generated by the size of insurance premiums. Prudential Ratings also considers the industry's earnings strength and quality from both an underwriting (operating for long-term industries) and net profitability perspective. Generally, industries demonstrating sound earnings strength and quality with potential to sustain such a trend over the medium to long term are considered credit positive.

In assessing financial soundness of an industry, Prudential Ratings looks at the balance sheet quality and strength of the industry, focusing on liquidity (asset-liability matching for long term industry) and capital strength and quality. Markets exhibiting prudent liquidity (and sound asset-liability matching) and capitalisation measures are seen to enhance the credit standing of the industry.

Lastly, Prudential Ratings value markets that proffer transparency and timeous provision of industry performance data, detailed market statistics either through public or private dissemination.

### Business Profile

The business profile assessment focuses on the scale (relative to the reference market) and diversification of an insurer's revenue sources and distribution channels to determine the



sustainability of the entity's business model. Factors considered include competitive position, revenue diversification, premium scale, and diversification as well as the volatility in those measures. Prudential Ratings believes an entity's business profile feeds into its financial profile given the interdependence between these two key rating factor categories.

### (a) Competitive position

The insurer's competitive position largely determines its ability to generate premium income, the major source of an insurer's revenue. This premium generating capability is in turn determined by the entity's franchise strength, brand loyalty and special relationships with key and strategic clients. Considerations regarding the strength and sustainability of these competences are also factored into the analysis.

Prudential Ratings assessment of competitive position falls within the below ranges.

| Competitive position      | Dominant | Very strong | Strong    | Intermediate | Limited   | Very limited |
|---------------------------|----------|-------------|-----------|--------------|-----------|--------------|
| <i>Key attributes</i>     |          |             |           |              |           |              |
| Market share (%)          | >40      | 25 - 40     | 10 - 24   | 5 - 9        | 2 - 4     | <2           |
| Relative market share (x) | >5       | 3.5 - 5.0   | 2.5 - 3.4 | 1.5 - 2.4    | 1.0 - 1.4 | <0.9         |

- Market share:** Measures the level of acceptance of an entity's brand relative to other brands competing for the same risks in the market. The size of an insurer's market share and its associated volatility has a significant bearing on the insurer's top line and is regarded as the building block to sound earnings given its influence on cost efficiency. It indicates the entity's ability to price risks which in addition to business volume feeds into the earnings stream. The assessment of market share is done in both absolute (gross and net) and relative terms. Prudential Ratings also positively consider market participants which are dominant players in their respective niche markets, bringing our definition of a market to the fore.
- Revenue scale and stability:** The stability of underwriting and net profitability is largely influenced by the scale of the premium base, with large insurers better placed to absorb volatility in underwriting and other operating costs. Prudential Ratings may however make negative adjustments in instances where an insurer has scale but writes off a substantial portion of booked premiums as bad debts, negating cost efficiencies priced in the assessment of insurers of large scale.
- Strategic direction:** The competitiveness of a business is guided by successful execution of the business strategy and how it is adapted to accommodate changing circumstances. For example, an insurer which used to be a major player in the motor insurance class may decide



to downsize the portfolio on account of high loss ratio to pursue other more profitable lines. As the entity executes this strategic shift, premium volumes from the less profitable line may adversely impact its market share, while trying to explore the other new lines. Prudential Ratings will examine the insurer's core competencies in the new focus area with the view of assessing its ability to penetrate and build acceptance in the new focus area.

**(b) Revenue diversification**

Insurers with a premium base that is well spread out by product line, market segment, distribution channel, uncorrelated jurisdictional markets and policyholder profile are better positioned to weather shocks emanating from a specific product line, market segment, or exposure to certain policyholders. That said, diversification must be meaningful and thus, Prudential Ratings does not reward bad diversification. Therefore, any diversification credit is made after factoring the impact of such diversity to underwriting profitability. Deliberations are also made in instances where an insurer derives income from other sources such fees attributable to pension administration and investment income that boosts overall profitability.

Our assessment of premium diversification is based on the below categories.

| Premium diversification   | Highly diversified            | Well diversified               | Diversified                      | Fairly diversified                  | Concentrated                        | Very concentrated       |
|---|-------------------------------|--------------------------------|----------------------------------|-------------------------------------|-------------------------------------|-------------------------|
| <i>Key attributes</i>   |                               |                                |                                  |                                     |                                     |                         |
| Number of core product lines at GWP and NWP level   | > 6                           | 5                              | 4                                | 3                                   | 2                                   | 1                       |
| Policyholder profile; largest and top 20 policyholders' contribution to GWP (%) respectively. | 0.0 - 1.0<br>and<br>0.0 - 5.0 | 1.01- 5.0<br>and<br>5.01 -10.0 | 5.01 - 10.0<br>and<br>10.01 - 15 | 10.01 - 20.0<br>and<br>15.01 - 30.0 | 20.01 - 30.0<br>and<br>30.01 - 50.0 | >30.01<br>and<br>>50.01 |

- Product diversification:** Credit is given to insurers exhibiting material product diversification at gross and net levels, both in absolute and relative terms. However, before such credit is considered, Prudential Ratings assesses the underwriting profitability of these diversified lines as well as the correlation of profit margins. Recognition is also made in instances where certain loss-making lines are used as conduits to write other offsetting profitable business from the same policyholders.



- **Distribution channel diversification:** Insurers whose products and services are distributed through a wide range of channels are better placed to withstand shocks that may arise from a particular distribution channel as other networks may continue to support premium generation. Furthermore, Prudential Ratings considers intra-channel diversification and values entities which distribute their products and services through direct selling and tied agencies. These two channels tend to provide entities with more control over the distribution network, which may be a source of premium stability.
- **Policyholder diversification:** Entities with significant exposure to single or a few policyholders are more susceptible to earnings shocks attributed to policyholder flight. Prudential Ratings values policyholder profiles that are well spread out as they tend to smoothen earnings when some accounts are lost or when new accounts are onboarded. Considerations are also made to special relationships that may exist between policyholders and underwriters as well as the sustainability of such relationships, even though policyholder profile may be concentrated. For example, an insurer may leverage off business opportunities available within the group's ecosystem to which it belongs, making such a relationship an offsetting factor if policyholder concentration to a related party is evident.
- **Market segment diversification:** Prudential Ratings also considers the spread of premiums by market segments, exposure to certain sectors of the economy and participation in government-related business to determine the degree to which these may affect the top line and underwriting performance when each of these factors change.
- **Jurisdictional market diversification:** Entities exposed to other jurisdictional markets that are not correlated to the primary market are considered positively if premium contribution from these markets are material.

### (c) Management and Governance

Prudential Ratings assesses the corporate governance structure of entities, risk management policies and procedures, and compliance with applicable laws, regulations, and international standards.

Evaluation of governance, risk management & compliance is conducted based on the below assessment levels.

| Score    | Description  |
|----------|--|
| Adequate | Management and governance is appropriately skilled management and governance structures for the size and complexity of the organization, for the execution of the bank's objective.  |
| Weak     | Management has a shown management and governance deficiency such as breach of laws or regulation, do not abide by corporate governance best practice, high management turnover, prevalence of key man risk, lack of succession planning, inadequate board oversight and overly complicated board structures. |

The following are some of the factors considered:

- The existence of an effective board of directors, constituted by a majority of independent board members.
- Independence and rotation of the chairperson, knowledge, qualifications, and experience of board members.
- The existence of sub-committees key to the effectiveness of the functioning of the main board, including the constitution and independence of members.
- The ability of the board and its subcommittees to hire independent third-party consultants without having to receive approval from management.
- The effectiveness of firm-wide risk management policies and procedures or any other risk governance framework.
- The adequacy of the in-force reinsurance or retrocession programme, maximum net retention exposure to capital and the credit quality and diversification of participating counterparties.
- Compliance with guidelines contained in applicable acts and regulations, material, and unsettled litigation cases against the entity.
- Opinions of external auditors and actuaries regarding the quality and reliability of input data.

## Financial Profile

The financial profile looks at the entity's performance and balance sheet strength. Rating factors considered include earnings strength and quality, capital adequacy and liquidity. The financial profile is considered the engine of an entity, determining its capacity to honour its contractual obligations.

### (a) Earnings strength and quality

Assessment levels

| Earnings assessment  | Very strong   | Strong   | Average   | Moderately weak   | Weak  | Very weak   |
|--|---|--|---|---|---|---|
| Underwriting margin (%) - short-term, Operating margin (%) - long-term | +10% above market average. Earnings quality is very high. | +2% to 10% above market average. Earnings quality is high. | In line with market average, with a margin of error of 1-2%. Earnings quality is average. | Below average performance, typically underperforming the market by 3 to 5%. Earnings quality is moderate. | Below average performance, typically underperforming the market by 5 to 10%. Earnings quality is weak | Below average performance, typically underperforming the market by greater than 10%. Earnings quality is very weak. |
| Return on revenue (%)  | +15% above market average. Earnings quality is very high. | +10 to 15% above market average. Earnings quality is high. | In line with market average, with a margin of error of 1-2%. Earnings quality is average. | Below average performance, typically underperforming the market by 3 to 5%. Earnings quality is moderate. | Below average performance, typically underperforming the market by 5 to 10%. Earnings quality is weak | Below average performance, typically underperforming the market by greater than 10%. Earnings quality is very weak. |

Prudential Ratings assesses the earnings strength and quality at both underwriting and net profitability level for short term insurers and at operating profitability level for composites and life insurers. In evaluating earnings strength and potential, reference is be made to local or primary market industry performance to determine the degree of outperformance or underperformance. Stability in performance profitability metrics is also an input, given their contribution to the solidity of the balance sheet. Prudential Ratings value underwriters whose earnings are derived from core operations, and thus gives more weight to underwriting profitability relative to net profitability.

For purposes of capturing the financial performance of insures over a full underwriting cycle, Prudential Ratings initially assesses the insurer's performance over a period of five years and build on year on year performance, thereafter up ten years. Discretion is however applied in instances where a break in performance due to various reasons such as a change in underwriting, management or reinsurance strategy, or regulatory regime is pronounced. In such cases, a shorter assessment period which may be more reflective of future earnings performance could be applied. Earnings of high quality are more preferred given their contribution to balance sheet strength should the investment strategy support the latter. In this respect, adjustments are made to earnings that



evidence weak quality which can be attributable to exposure to outstanding receivables or a greater proportion of unrealised income.

In assessing earnings strength and potential, Prudential Ratings evaluates the sufficiency of reserving levels relative to market norms and make necessary adjustments if such provisions are deemed inadequate. In this respect, entities with reserves that are independently assessed, and satisfy the sufficiency test are more likely to be spared of this adjustment provided their reserving metrics are in line with observed local market norms. For underwriters whose earnings are more reliant on commission recoveries due to inordinate utilisation of reinsurance protection, regardless of the nature of relations with participating counterparties, Prudential Ratings assesses potential earnings risk that may arise from changes in these counterparties' risk appetite, including reinsurers' profitability on ceded business. In addition to the above adjustment, Prudential Ratings may make other adjustments it deems necessary to reflect the quality of earnings. These may pertain to aged receivables (premium, reinsurance, or rental) or other material irrecoverable balances especially in markets which have not yet adopted IFRS 9 or markets that do not follow IFRS.

### (b) Capital adequacy

#### Assessment levels

| Capital adequacy       | Very Strong | Strong       | Intermediate | Moderately Weak | Weak         | Very Weak |
|------------------------|-------------|--------------|--------------|-----------------|--------------|-----------|
| Capital adequacy ratio | >2.5x       | 2.01x - 2.5x | 1.51x - 2.0x | 1.01x - 1.5x    | 0.75x - 1.0x | <0.75x    |

Prudential Ratings believes the strength of an insurance entity is largely determined by the soundness of its balance sheet. In this respect, insurers with a very strong capital base (and good asset quality) relative to its aggregate risk exposures stand better chance to withstand unforeseen earnings shocks that may arise through the underwriting cycle. In evaluating risk adjusted capitalisation, the agency looks at admitted capital coverage of aggregate risks exposures. Underwriters with substantial risk adjusted capitalisation coverage score more on capital adequacy given their ability to absorb risk exposures without raising external funding. In determining admitted capital, assets that are not available to meet policyholders' obligations and assets balances in excess of predetermined concentration limits are stripped from the capital balance. These include but not limited to aged receivables, encumbered assets, net deferred tax assets, intangible assets (including right of use assets), proposed dividends while capital guarantees and drawdown facilities may be added to capital if certain conditions are met.

Prudential Ratings assessment of aggregate risk exposures considers the following:

**Insurance / underwriting risk:** It is the risk that premiums charged may not be sufficient to cover the cost of providing insurance. Insurers that make losses at underwriting level are more susceptible to significant insurance risk charges, negatively impact on the overall capital adequacy ratio.

**Market risk:** It is the risk associated with changes in interest rates, exchange rates, stock and commodity prices on asset values.

**Credit / counterparty risk:** Refers to the risk of loss caused by a counterparty or debtor's failure to make a promised payment when it falls due.

**Operational risk:** It is the risk of loss arising from failures in company's systems and procedures or from external events. Operational risk sources include computer breakdowns (hardware and software), human error, and events outside the company's control, including "acts of God" and terrorist actions.

Consideration is also given to regulatory risk in instances where a statutory capital breach has been observed or is projected to occur in the near term. The underwriter's approach to capital management is also factored into capital adequacy assessment as it relates to the investment strategy and dividend distributions. In instances where shareholders have demonstrated capacity and willingness to offer capital support in times of financial stress, Prudential Ratings considers this potential capital provided certain conditions are satisfied. The same approach is followed on insurers which are listed on active exchanges and subsidiaries of listed groups given their ability to raise funding on capital markets. While risk adjusted capitalisation and the associated adjustments explained above carry more weight in capital adequacy assessment, Prudential Ratings also considers the scale of capital, thus limiting maximum scoring if certain thresholds are not met.

### © Liquidity and asset liability matching

Assessment levels

| <b>Liquidity</b>         | Very strong | Strong        | Intermediate   | Moderately weak | Weak           | Very weak |
|--------------------------|-------------|---------------|----------------|-----------------|----------------|-----------|
| Stressed liquidity ratio | >2.0x       | 1.51x to 2.0x | 1.01x to 1.50x | 0.751x to 1.0x  | 0.51x to 0.75x | <0,50x    |
| Current liquidity ratio  | >1.5x       | 1.01x to 1.5x | 0.75x to 1.0x  | 0.50x to 0.74x  | 0.25x to 0.49x | <0,25x    |

| Asset-liability matching | Above average  | Average   | Below average   |
|--------------------------|--|---|---|
| Cashflow matching        | Asset and liability maturities are largely matched, with more than 75% of maturity buckets exhibiting adequate coverage of policyholders' liabilities. | Asset and liability maturities are matched, with more than 50% of maturity buckets exhibiting adequate coverage of policyholders' liabilities.                    | Asset and liability maturities are somewhat matched, with less than 50% of maturity buckets exhibiting adequate coverage of policyholders' liabilities. |
| Duration matching        | Duration of interest-sensitive assets and interest sensitive liabilities is adequately matched with very minimal margin of error of less than 50bps.   | Duration of interest-sensitive assets and interest sensitive liabilities is moderately matched with a margin of error of greater than 50bps but less than 100bps. | Duration of interest-sensitive assets and interest sensitive liabilities is unmatched with a margin of error of greater than 100bps.                    |

The underwriter's ability to meet policyholders' and other obligations when they fall due is one of the most important measures of financial strength. This ability is largely dependent on the quantum of the insurer's investment portfolio and the associated asset quality. Highly liquid insurers are able to meet their obligations from cash and equivalents, without untimely sale of investments which may attract significant discounts due to temporary market conditions and or tax consequences.

Liquidity is particularly important for short term insurer given the uncertainty in both claims value and timing of the claim. For this reason, general underwriters need to have the majority of their investments in liquid form and shy away from long term assets such as investment property and equities unless they have sufficient cash buffers to meet these unexpected obligations. Due to the inherent lack of marketability associated with unlisted property and equity investments, Prudential Ratings does not include these assets in assessing liquidity when there is lack of convincing evidence of monetising these assets in the near term. Prudential Ratings however applies certain market risk charges to quoted equities and other tradable debt instruments before considering these assets in liquidity assessment. For general insurers, the following ratios are considered:

**Liquidity ratio:** Measures the coverage of net technical obligations by cash, stressed tradeable and collectible assets.

**Current liquidity:** The ratio indicates the insurer's ability to meet its obligations from the liquid asset pool without prematurely selling its long-term investments or borrowing. A ratio below 1.0 indicates that the insurer's liquidity is sensitive to cash flow from premium collections.



The major difference between life insurer and a general insurer lies in the nature and duration of obligations. The liabilities of a general insurer are short term while those of a pure life insurer are typically long dated. Furthermore, the liability value of a long-term insurer is known in advance, although liability timing remains uncertain for some products, while liabilities for some products such as endowments and annuities may be known with some degree of reliability. Given the certainty in the claims value coupled with an element of predictability in timing for uncertain obligations (such as whole or term life policies) through the use of mortality tables, long term insurers may invest in assets whose value is capable of tracking the value of the liability (they can construct a portfolio of liability mimicking assets) or invest in assets that closely tracks the maturity profile of their obligations, thus minimising liquidity risk. For long term insurers, Prudential Ratings considers a combination of the following dedication strategies:

**Cash flow matching:** A strategy that involves timing of cash inflows from invested assets to match the maturity profile of policyholders' obligations.

**Portfolio immunisation (duration matching):** Refers to a strategy in which the duration of interest-sensitive assets is matched with the duration of interest-sensitive liabilities. When a portfolio of interest-sensitive securities is immunised, changes in interest rates will not affect the portfolio's ability to meet policyholders' obligations.