

Claims Paying Ability / Financial Strength Rating Methodology for Insurance Companies

CRAF’s Claims Paying Ability (CPA) / Financial Strength Rating (FSR) is an opinion on an insurance company’s financial strength and measures its ability to honour policy claims as per contractual commitments. The opinion is not specific to any particular insurance policy or contract. CRAF’s CPA rating does not apply to non-policy obligations of the insurer, such as debt, nor does it address the suitability of terms of any individual policy or contracts. Additionally, the rating does not take into account deductibles, surrender or cancellation penalties, timeliness of payment nor the likelihood of the use of a defense like fraud to deny claims. The rating does not take into account any limitation that the insurers might face in settling its foreign claims due to exchange control/sovereign restrictions that might be placed on foreign currency payments by the Government. CRAF’s CPA rating is not a recommendation to buy, hold or sell/terminate any security/insurance policy.

Benefits of CPA rating The CPA rating is primarily useful to:

- a) Buyers of insurance cover: Aids existing as well as potential customers to evaluate the insurer’s ability to service policy commitments as and when claims arise.
- b) Insurance/Reinsurance Company: Helps the company in showcasing its financial strength and consequently increase its business opportunities. An independent opinion on financial strength also provides critical inputs for management.
- c) Insurance Agents: Aids in selling insurance products.

Methodology:

CRAF’s CPA rating analysis begins by a review of the economy and the industry in which the insurance company operates. The nature of insurance regulation and the competitive position of the company are also examined. CRAF then applies the “RAMELS” framework to assess the financial strength of the subject insurance company. No one factor is considered in isolation but all factors are viewed in conjunction before assigning a rating.

R :	Risks Underwritten
A :	Asset Quality
M :	Management
E :	Earnings
L :	Liquidity
S :	Solvency Margin

Detailed methodology based on the RAMELS framework is given below:

1.1. Risks Underwritten

Analysis of risks underwritten constitutes the key element in a CPA rating assessment and plays a vital role in the final outcome of the rating assigned. The efficacy of a firm's underwriting strength is brought out by its historical claims experience, degree of diversification in risks underwritten and the relative growth in business volumes. CRAF also evaluates the pricing of insurance products, proportion of long tail business as well as exposure to lumpy risks such as catastrophe covers. Each business segment of the insurer is analysed in depth with an emphasis on understanding its unique competitive characteristics that would drive future earnings potential or cause deterioration in financial strength. Following factors are considered while analyzing the business segments of the insurer:

- Market share
- Geographical spread
- Diversity of the risks underwritten
- Pricing policy
- Underwriting expertise
- Competitive advantages
- Mix of tariffed and non tariffed products
- Product innovation
- Proportion of long tail business
- Claims experience and exposure to lumpy risks such as catastrophe covers

A quantitative and qualitative assessment of the above factors is carried out by analyzing the trends in premium income, reinsurance ceded, claims experience and expenses incurred on reinsurance business over a five year time span. Apart from the above, CRAF also assesses the current as well as potential underwriting capacity by analyzing the firm's operating leverage. CRAF also examines the insurer's reinsurance programme, terms of reinsurance, financial strength of reinsurers and the company's processes employed to monitor, collect and settle outstanding reinsurance receivables.

1.2. Asset Quality

Claims Paying Ability of an insurer could be hampered by future losses on its investment portfolio. In respect of insurance entities, asset quality assumes a greater dimension as it influences not only the level of income but also has a direct bearing on the insurer's ability to provide instant liquidity. Insurance entities are susceptible to credit as well as market risk on their asset portfolio similar to banks. In this regard, CRAF analyses the quality and diversification of assets across various classes. As most of the asset deployment decisions are largely guided by certain regulatory constraints, CRAF reviews the insurer's level of adherence to regulatory norms and assesses its performance under the specified constraints. CRAF also measures the degree of success of the asset deployment strategy vis-à-vis the slated goals of maintaining a fair degree of liquidity, yield optimization and capital protection. In this context, CRAF broadly examines factors such as:

- Investment philosophy and strategy vis-à-vis the insurer's risk profile

- Portfolio diversification
- Credit quality of investments
- Level of non performing investments and its NPA recognition norms
- Adequacy of provisioning and
- Liquidity of the investment portfolio

1.3. Management

Management quality is a very important qualitative aspect, which can make a substantial difference to a company's performance. Insurers must be able to demonstrate that they have growing, profitable business with staying power. In this context, CRAF scrutinizes the management's goals, mission, philosophy etc. and reviews the corporate strategy laid down to achieve the stated goals. CRAF analyses the operational objectives assigned to individual teams or divisions to understand their relevance to the overall corporate strategy which has a direct bearing on key operational parameters. This involves a process wherein CRAF's team undertakes discussions with key executives to understand the insurance companies' perspectives on the strategies and plans designed to counter environmental challenges from all fronts. Thus, experience and depth of management to tide over periods of crisis is recognised as a favourable attribute. CRAF also examines the financial strength and track record of the promoters, the degree of group support enjoyed particularly at times of stress, nature of business plans and targets, experience of key executives manning important positions and the degree of technology orientation. Strong parentage and group support is viewed favourably by CRAF and is examined with respect to past proven support and assurances of future support.

1.4. Earnings

Profitable operations are necessary for insurance companies to operate as a going concern. CRAF's measurement of earnings focuses on an insurer's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable profit margins. CRAF analyses the profitability of the underwriting and investment functions separately.

Underwriting Performance

Underwriting profitability is impacted by the level of premium income, agency commission, staff costs and claims experience. Following ratios are analyzed to gauge the underwriting performance of an insurer:

- Premium Growth
- Risk retention
- Loss ratio
- Expense ratio
- Combined ratio
- Investment Ratio
- Operating Ratio

Performance of Investment operations

Investment income is largely a function of the investment strategy followed by the company. The behavior of the securities market and interest rate movements also influence the returns on the investment portfolio. CRAF examines the following to assess the performance of investment operations in terms of investment yield. Market risk and its probable impact on earnings is also examined.

Overall profitability tests

CRAF analyses a few ratios to assess the overall profitability of the insurer. These ratios are analysed over the past few years and compared with the industry benchmarks.

- Return on revenue (ROR)
- Return on Net worth
- Return on Assets

1.5. Liquidity

Good liquidity helps an insurance company to meet policyholder's obligations promptly. An insurer's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid or through operating cash flows. A high degree of liquidity enables an insurer to meet the unexpected cash requirements without untimely sale of investments, which may result in substantial realized losses due to temporary market conditions and/or tax consequences. Some of the ratios examined by CRAF for assessing the liquidity of an insurer include:

- Measurement of liquid assets vis a vis technical reserves
- Current Liquidity
- Operating Cash Flow

While analyzing an insurer's liquidity, CRAF would critically examine the Asset Liability Maturity (ALM) profile of the insurer. CRAF would also examine the impact of stress tests on the ALM to understand the shock absorbing capacity in the event of an unforeseen loss of confidence, sudden catastrophe losses or wide fluctuations in the security markets.

1.6. Solvency

Adequacy of solvency margin forms the basic foundation for meeting policyholder obligations. All insurance companies are required to comply with solvency margin requirements of the regulator. CRAF further analyses the impact of changes in key variables on solvency margin to ascertain the strength of the insurer.

Apart from the above, CRAF also assesses the current as well as potential underwriting capacity through an analysis of a firm's Operating Leverage.

Reserving Policy

CRAF would study the reserving policy of the insurer and would examine the claims experience vis-a- vis the reserves created. The shortfall in reserves, if any, would then be compared with the insurer's net worth.

Apart from relying on regulatory guidance on prescribed solvency levels, CRAF would assess the capital adequacy of the insurer. CRAF believes that capital adequacy addresses the impact of all dimensions of risk in the long term and therefore helps in arriving at a realistic level of risk.

Disclaimer

CRAF's ratings are opinions on credit quality and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security or to invest in or withdraw funds from deposits. CRAF has based its ratings on information obtained from sources believed by it to be accurate and reliable. CRAF does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments/deposits are rated by CRAF have paid a credit rating fee, based on the amount and type of bank facilities/instruments/deposits.

In case of partnership/proprietary concerns, the rating assigned by CRAF is based on the capital deployed by the partners/proprietor and the financial strength of the firm at present. The rating may undergo change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor in addition to the financial performance and other relevant factors.