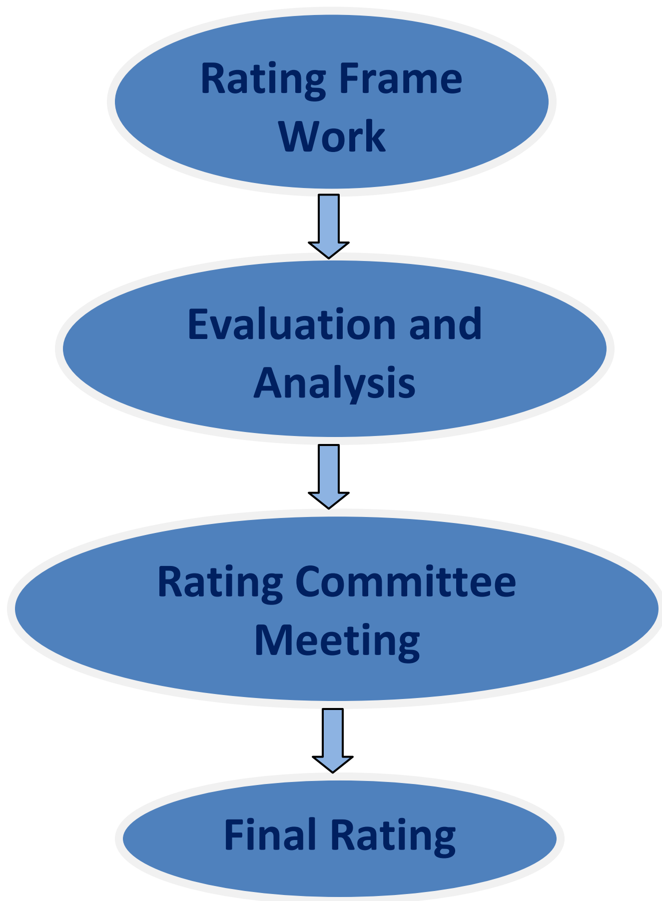
INSURANCE RATING METHODOLOGY

ARGUS CREDIT RATING SERVICES LIMITED

RATING PROCESS FLOW



ACRSL's Rating Methodology - Insurance

ACRSL’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. ACRSL then applies the “CARAMELS” 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.

A detailed methodology based on the CARAMELS framework is given below:

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. ACRSL also evaluates the pricing of insurance products, mix of tariffed and non-tariffed businesses, proportion of long tail business as well as exposure to lumpy risks such as catastrophe covers. Each business segment of the insurer is analyzed 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, ACRSL also assesses the current as well as potential underwriting capacity by analyzing the firm's operating leverage.

ACRSL 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.

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, ACRSL analyses the quality and diversification of assets across various classes. As most of the asset deployment decisions are largely guided by certain regulatory constraints, ACRSL reviews the insurer's level of adherence to regulatory norms and assesses its performance under the specified constraints. ACRSL 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, ACRSL 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

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, ACRSL scrutinizes the management's goals, mission, philosophy etc. and reviews the corporate strategy laid down to achieve the stated goals. ACRSL 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 ACRSL'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 recognized as a favourable attribute.

ACRSL 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 ACRSL and is examined with respect to past proven support and assurances of future support.

Earnings

Profitable operations are necessary for insurance companies to operate as a going concern. ACRSL'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. ACRSL 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. ACRSL 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

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

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

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 ACRSL 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, ACRSL would critically examine the Asset Liability Maturity (ALM) profile of the insurer. ACRSL 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.

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. ACRSL further analyses the impact of changes in key variables on solvency margin to ascertain the strength of the insurer. Apart from the above, ACRSL also assesses the current as well as potential underwriting capacity through an analysis of a firm’s Operating Leverage.

Reserving Policy

ACRSL 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, ACRSL would assess the capital adequacy of the insurer. ACRSL 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

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