INSURANCE COMPANY CREDIT RATING METHODOLOGY

Credit rating provides an opinion on the credit risk associated with the instrument being rated. The process involves projecting and estimating the issuer's capacity to generate the cash flows from operations and determining the adequacy of the cash flows to meet the issuer's debt servicing obligation over the life of the instrument. This methodology describes the approach used by Infomerics Nepal to access the credit risk prevailing in the entity in the Insurance sector.

Infomerics Nepal follows the RAMELS framework to base its ratings on Insurance Companies. RAMELS implies Risks Underwritten, Asset Quality, Management Composition, Earnings, Liquidity and Solvency Margin. In addition to these, Infomerics Nepal also considers the market positioning of the entity being rated. These parameters/ variables significantly determine the ability to manage risk, price fluctuation, while maintaining adequate capitalization to absorb losses of insurance company.

Risks Underwritten

Evaluating risks underwritten is very important for arriving at rating of insurance entities. Infomerics Nepal's goal is to evaluate the health of the book of business, and management's understanding of underwriting risks and ability to control them. Key areas considered are:

- Performance versus pricing margins, including impact of investment income on pricing decisions.
- Performance relative to market peers.
- Volatility of underwriting results over time.
- Expense efficiencies and impact of ceding commissions on expense ratios.

To assess the applicable ratios in the Financial Performance and Earnings Ratio, Infomerics Nepal considers business mix, pricing strategy, accounting practices, distribution approach and reserving approach.

Asset Quality

Like Banks, Insurance entities are susceptible to credit as well as market risk on their asset portfolio. Therefore, the quality and diversification of assets across various classes is analyzed. Because the majority of asset deployment decisions are generally dictated by regulatory limitations, it is critical to analyze the insurer's level of adherence to regulatory norms and its performance within those constraints. Also, Infomerics Nepal measure the asset deployment strategy's performance in terms of the intended goals of maintaining a reasonable level of liquidity, yield optimization, and capital protection.

In addition to the above, Infomerics Nepal examine the following factors:

- Portfolio diversification
- Investment philosophy and strategy with regards to the insurer's risk profile
- Credit quality of investments
- Level of non-performing investments and its NPA recognition norms
- Adequacy of provisioning and
- Liquidity of the investment portfolio

Management Composition

Here, culture, attitude, employee involvement and composition of board are taken into consideration. It also focuses on satisfaction of all stakeholders, have a sustained customer focus and apply continuous improvement with facts and database. It deals with capabilities of senior management, degree of computerization, degree of group support, personnel policies and extent of delegation of powers. Following are considered to gauge the managerial competence:

- Reduced cost of operations
- Mobilization of resources
- Ability to identify opportunities
- Track record in managing stress situations

- Track record of labor relation
- Adoption of modern technology and systems

Earnings

Insurer's profitability is a combination of its underwriting result and its investment income. Infomerics Nepal evaluates both the underwriting result and the investment income and also looks at core profitability before capital gains and dividends paid out to policy-holders.

For an ongoing concern, profitable operations are necessary, hence, a measurement of earning that focuses on an insurer's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable profit margins.

Liquidity

Insurance companies with good liquidity would be able to meet its policyholder's obligations promptly. Some of the ratios examined for assessing the liquidity of an insurer are:

- measurement of liquid assets with regards to technical reserves
- current liquidity
- operating cash flow

The insurer's Asset Liability Maturity (ALM) profile is scrutinized in order to assess its liquidity. The impact of stress testing on the ALM shall also be investigated in order to determine the shock-absorbing capability in the event of an unanticipated loss of confidence, abrupt disaster losses, or large volatility in the security market. Infomerics Nepal also examines investment portfolio of the insurer whether it is readily marketable or not.

Solvency Margin

All insurance companies are required to comply with solvency margin requirements of the regulator. The influence of changes in important variables on solvency margin must be examined in order to determine the insurer's strength.

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