Insurance Methodology

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1. Introduction

This methodology outlines SAR's fundamentals and analytical approach to assigning issuer credit ratings, financial strength ratings, and financial instrument ratings to insurance organisations and medical schemes. The methodology is used to assess insurance and medical scheme companies' (herein "issuers") ability to meet their financial obligations to policyholders and other creditors. The assessment considers a variety of factors, including the operating environment, the company's financial strength, operating performance, business profile, and enterprise risk management. SAR uses scorecards in its approach, wherein each factor is scored individually and the scores are then weighted to produce a final rating. The weights assigned to each factor will vary depending on their relative impact on financial strength and creditworthiness.

2. Methodology Overview

Pillar	Weight	Attribute	Weight
Market Context and Environment	20%	Country Risk	8%
		Industry Risk	12%
Business Performance	30%	Competitive Advantage	23%
		ESG Factors	7%
Capitalisation, Liquidity, and Earnings	40%	Capitalisation, Liquidity, and Leverage	23%
		Financial Performance and Earnings	17%
External Support and Comparative Analysis	10%	Support	5%
		Peer Analysis	5%
	100%		**100%**

2.1. Pillar 1: Market Context and Environment

The Market Context and Environment pillar assesses registered insurers in accordance with the laws in force in the relevant jurisdiction of operation. A ranking of creditworthiness is produced as a result of the ratings, which offer an opinion on the relative capacity of an issuer to pay back its debt obligations.

Attribute 1: Country risk

In determining the sovereign risk score, SAR will rely on its assigned sovereign credit rating for any country (or countries) where the rated entity has significant operations and exposure. However, if no such rating is assigned for a particular country, SAR's sovereign analysts will perform an assessment utilising the sovereign rating methodology and present a recommended sovereign risk score for that country as part of the analysis. In instances where the rated entity has significant operations and exposure in multiple countries, a weighted average approach will be employed when assessing country risk.

The transmission of shocks across different economic sectors and the domestic financial system is something that issuers in the same sovereign context are somewhat subject to. Additionally, they are vulnerable to cautionary sovereign actions, such as the imposition of austerity measures, adjustments to taxes or laws, and government intervention.

It is worth noting that SAR's insurance ratings are based on the merits of the rated issuer and therefore does not apply sovereign rating ceilings to rated insurance companies and cell captives. Country risk is, however, factored into the rating process through the country risk assessment, which considers a weighted average of significant operational exposures.

Attribute 2: Industry Risk

SAR assesses an issuer's market and general operating environment from a variety of perspectives to determine its relative strengths and weaknesses. The overall industry outlook is assessed by considering factors such as economic and financial conditions, demographic trends, product/service offerings, and regulatory changes. The industry landscape of an issuer is assessed by considering a variety of factors, including:

Regulatory Oversight: SAR assesses the development of regulatory practises in accordance with international standards, such as the type of capital oversight, the methods used for supervision, the authorities' regulatory effectiveness, enforcement action record, and whether the enforcement procedures are carried out in a clear and consistent manner. SAR also assesses the regulatory authorities' ability to foster stability in the issuer's industry by assessing the effectiveness of the regulations on product pricing requirements, mandated products, and resultant profitability for issuers. Changes to regulations can have a significant impact on the profitability and risk profile of issuers.

SAR will consider the issuer's obligations to compliance that serve to mitigate business risk(s). This will range from undergoing periodic independent reviews, to honouring specific reporting requirements or following industry best practices. In each case, SAR will assess the issuer's compliance with applicable regulation to the extent that this does not overlap with other attributes (i.e., where an issuer is required to report its leverage metrics, the leverage assessment will be undertaken as part of the credit profile review and not in this section).

Barriers to Entry: SAR assesses this sub-factor by considering regulatory requirements and the presence (or the lack thereof) of competition promotion. High barriers to entry due to regulatory requirements may have beneficial or harmful consequences for the industry. SAR, however, views anti-competitive practices as an indicator of inefficiencies. SAR therefore conducts a qualitative assessment in this respect.

Financial Markets Depth: SAR assesses this variable by considering both macroeconomic conditions and market conditions. The evaluation of macroeconomic conditions comprises an assessment of the strength of the legal and regulatory frameworks, adequacy of market infrastructures, and the depth of the local investor base measured by the pension system.

The market conditions assessment incorporates depth, liquidity, and diversification of markets across asset classes, fixed income, equities, money markets, and derivatives by considering the strength of the following metrics: bank deposits/GDP(%), pension fund assets/GDP (%), mortgage debt stock/GDP(%), number and value of daily (weekly) transactions in money markets, new issues and growth in outstanding value in money markets, volume and value of daily foreign exchange transactions, (capital markets) market capitalisation/GDP(%) and value traded/market capitalisation(%), size of the derivatives market and (collective investment schemes) total number of assets and growth rates/GDP(%), and the average balance per scheme.

Access to Capital: Issuers need access to capital to meet their financial obligations to policyholders and other creditors. The capital and financial market can provide these issuers with access to a variety of sources of capital, such as equity and debt. A company with a high credit rating is likely to be able to raise capital at a lower cost than a company with a low credit rating; however, this can be affected by the capital and financial market's level of development and efficiency.

Investment Performance: Issuers typically invest a significant portion of their assets in the capital and financial market. SAR therefore also assesses the liquidity of the investment market, as this has a bearing on the performance of these investments and can have a significant impact on the issuer's financial results.

2.2. Pillar 2: Business Performance

Attribute 1: Competitive Advantage

Diversification: This sub-factor accounts for various market segments, regions, and distribution channels. Diversified earnings and revenue streams are viewed positively in the assessment; however, diversifying into markets without having enough capacity may result in significantly worse short- to medium-term performance. SAR will assess whether an issuer's strategy leads to diversification or concentration and assess if this results in increased earnings and revenue streams. In SAR's view, geographic diversification reduces exposure to systemic risks unique to a particular jurisdiction. In short, limited geographic and product/service diversification are credit negatives, as they may negatively impact an issuer's balance sheet strength and operational performance.

Market share: An issuer's market share is an assessment of its size and importance in the insurance industry. A higher market share indicates a stronger market position.

Competitive Position: An issuer's competitive position relative to its peers is assessed by considering factors such as its product offerings, pricing, client retention, and growth. The level of competition from sources outside the traditional market, or from abroad, is also assessed to determine whether it is favourable to issuers attaining fair company development and adequate returns. A strong competitive position indicates that the issuer is able to compete effectively in the marketplace.

SAR will assess the diversity of operational lines and stability of income from each stream when determining the competitive advantage score. For entities with diverse operations, each significant business line will first be assessed on a standalone basis relative to peers in the market and based on its historical performance. Competitive divisions with a strong customer base and stable high profits will support a high competitive position score, whereas having multiple business lines that are relatively weak compared to their peers and that have poor historical performance will result in a low score. Vertically integrated entities that have strong and stable divisions that create synergies within the group and lead to the retention of profits will be positively considered.

SAR also assesses the expense ratio, claims ratio, and retention ratio to determine the insurer's efficiency in controlling its expenses in a way that it can effectively meet its obligations, net claims against earned premiums, and underwritten policies against those ceded to reinsurance.

Management Team: The experience and expertise of the issuer's management team are also assessed, since a strong management team is more likely to make sound business decisions.

Attribute 2: Environmental, Social, and Governance Factors (ESG)

SAR conducts a holistic evaluation of ESG factors by considering several subcategories for each factor as well as the related mitigation systems in place.

Environmental Factor: SAR reviews the following subcategories – the level of use and distribution of packaging and paper; the rate of underwriting exposure to entities that suffer losses related to environmental concerns; litigation and controversies and the level of green finance investment; exposure to high-cost and volatile energy sources and emissions in comparison to the industry average; and the use of renewables.

Social Factor: SAR reviews the following subcategories – human resource development to assess workforce productivity and the insurer's ability to attract, train, and retain skilled labour; community engagements and relations to assess the insurer's customer treatment and corporate social responsibility policy effectiveness; customer financial protection; personal information management; as well as health and safety.

Governance Factor: SAR reviews the following subcategories – board composition to determine its appropriateness and compliance with industry standards; ethics in terms of oversight and management of ethical matters such as corruption, personnel misconduct, fraud, and money laundering; and lastly, accounting practices and tax compliance and transparency.

2.3. Pillar 3: Capitalisation, Liquidity, and Earnings

Attribute 1: Capitalisation, Liquidity, and Leverage

Risk-Based Capitalisation: The capital adequacy ratio (CAR), which assists in identifying an issuer's balance sheet strength and determining whether its capitalisation is acceptable, is the main quantitative tool used to assess an issuer's balance sheet strength. In assessing the capital adequacy ratio, SAR may analyse an issuer's underwriting, financial leverage, and asset leverage separately. The available capital is contrasted to the net required capital to sustain the financial risks related to an issuer's assets and underwriting being exposed to unfavourable economic and market conditions. This shows the issuer's balance sheet strength in relation to its operating risk. In the CAR assessment, SAR considers the underwriting risk, investment risk, operational risk, asset quality, liquidity, and the size and complexity of the issuer. This allows for a comprehensive assessment to determine the capital adequacy risk.

Regulatory Capital: SAR also assesses the regulatory environment in which the issuer operates to identify potential challenges, which includes a comparative assessment against the regulatory capital minimum. SAR's view will be guided based on whether the jurisdiction in which the issuer reports is subject to the same or equivalent regulations to the international Solvency-II regime, and whether there is significant headroom above the regulatory capital minimum. If the insurer's CAR is below the regulatory minimum, it is considered to be under-capitalised. Under-capitalised insurers will be required to take steps to improve their capital position, such as raising additional capital or reducing their risk exposure.

Financial Leverage: In assessing financial leverage, SAR conducts comparative assessments of debt against the level of capital using several ratios. SAR has developed thresholds for measuring debt burden and serviceability. These include measuring debt to capital excluding goodwill, debt to capital adjusting for hybrid securities, and debt to capital before adjusting for hybrid securities.

Asset Leverage: Assets funded by debt are expected to generate sufficient cash flows to meet the related interest and principal financial obligations. SAR therefore evaluates debt (or debt-like instruments) used to fund a specific pool of matched assets. This type of debt will be excluded from the financial leverage assessment.

Solvency Metrics: Solvency metrics measure the financial strength of an insurance company and its ability to meet its obligations to policyholders. Some of the solvency metrics SAR evaluates include (i) the capital adequacy ratio (CAR), which measures the amount of capital that an issuer has in relation to the risks that it faces, (ii) debt metrics, which measure the amount of debt that an issuer has in relation to its total equity and assets, and (iii) earnings coverage, which measures the issuer's earnings in relation to interest payments on its debt.

Underwriting Performance: SAR assesses the issuer's underwriting performance over time to identify any potential problems. Products with higher levels of potential instability and reserving uncertainty tend to have larger capital requirements. An issuer's underwriting risk profile is examined, since underwriting differs by line of business and high-risk lines with unpredictable loss histories can influence an issuer's stability, especially if it is undercapitalised and/or has low liquidity.

Investment Portfolio: SAR assesses the insurer's investment portfolio to identify any potential risks. The investment management performance is assessed to ascertain the adequacy of return as a contributor to capital and operating earnings and peer comparisons. Diversification of investment across geographical locations and industries is also assessed to determine if there exists high concentrations (15% or above) or high exposure to illiquid instruments, which may impact SAR's view of the issuer's investment risk and the timely sale of the instruments to maintain policyholder surpluses.

Liquidity: An issuer's liquidity indicates its capacity to fulfil its expected short- and long-term obligations to policyholders and other creditors. The degree to which one can meet one's financial obligations with cash on hand and sound investments through operating cashflow determines one's liquidity. Increased liquidity availability helps an issuer fulfil unforeseen financial needs without having to sell investments or fixed assets prematurely, especially since it is important to prevent losses from transient market fluctuations and/or tax repercussions. SAR's liquidity assessment is conducted at the issuer and holding company level. SAR would examine whether operational and net cashflows are stable and sufficiently significant to meet some liquidity needs. Typically, SAR would examine liquidity limits such as covenants and demands for further collateral through collateral calls, as well as an assessment of access to the capital markets, and availability of emergency lines of credit. Stress test scenarios are also conducted to assess short-term (one month) and long-term (six to 12 months) cash requirements in stress scenarios.

Reserve Adequacy: SAR will evaluate whether there are sufficient reserves on hand to ensure that they are kept at appropriate levels to lessen the likelihood of a shortfall. Positive patterns in the total loss reserve development along with a consistent methodology for setting up reserves for claims are assessed more positively.

Size and Complexity: SAR will evaluate an issuer's size relative to market peers as well as complexity in terms of corporate structure and risk correlation of product/service offering. Relatively larger and more complex issuers are expected to maintain relatively higher levels of capital and reserves by ensuring sufficient liquidity and favourable leverage metrics.

Attribute 2: Financial Performance and Earnings

The entity's financial performance affects its capacity to raise capital, its capacity to handle unfavourable variances, and its capacity to maintain financial flexibility. High-quality earnings stem from dependable and predictable sources, like consistent underwriting profits. Conversely, earnings from highly concentrated investments in riskier assets, inflation-driven earnings, and "one-off" factors such as gains on asset sales or withdrawals from reserves are all looked upon less favourably. SAR will assess operational performance from the perspective of sustainability and stability of the issuer's sources of earnings contrasted to its liabilities. This assessment will include the diversity of earnings (life, non-life, and non-insurance operations), investment income, net income, and volumes of premiums. Volatility in an issuer's earnings is specifically assessed against the impact this has on balance sheet strength and capitalisation. The financial statements of the issuer will be reviewed to assess trends in earnings.

The market demand for investments and the liquidity of assets in relation to liabilities are the main considerations in the appraisal. In addition, SAR accounts for the level of other assets, such as related holdings or real estate, as well as the quantity of receivables and other balances. To finance unforeseen cash needs, alternative sources of liquidity are assessed according to their quantity and accessibility. A holding company is considered cautious if it keeps its cash holdings at a level that is a reasonable multiple of its yearly cash demands, such as those for debt servicing.

Profitability Metrics: Some of the profitability metrics SAR evaluates include (i) the net income margin; this metric measures the percentage of revenue that is left over after all expenses have been paid. (ii) Return on equity (ROE); this metric measures how profitable an issuer is in relation to the equity that it has invested in the business, averaged over four years. (iii) Combined ratio; this metric measures the ratio of incurred losses and expenses to earned premiums.

Efficiency Metrics: Efficiency metrics measure how efficiently an issuer uses its resources. Some of the efficiency metrics that SAR evaluates include (i) Loss ratio; this metric measures the ratio of incurred losses to earned premiums. (ii) Net earned premium growth; this metric measures the percentage increase in net earned premiums from one period to the next.

SAR uses these financial performance metrics to track the issuer's performance over time and identify risk areas. SAR may incorporate an additional set of financial performance metrics relevant to an issuer type and business strategy.

2.4. Pillar 4: External Support and Comparative Analysis

Attribute 1: Support

Explicit or tacit support from an insurer's parent, subsidiary, or affiliated companies may ultimately affect that company's credit rating. We are able to factor support from a parent company or affiliate into the rating by minimising the discrepancy (expressed in the number of rating notches) between the standalone credit profile of the business or securities and the rating of the entity providing the support. SAR will conduct an evaluation to determine implicit and explicit support from a parent company or affiliates when making considerations for notching up to a maximum of two notches.

An issuer is typically rendered weaker by its relationships with financially troubled or weaker companies. Within a group, capital often flows from stronger to weaker companies. The most common forms of explicit support are a capital maintenance agreement, a minimum net worth agreement, or a direct guarantee of some kind. Moreover, marketing plans, reinsurance agreements, and management contracts may be used. A group member's strategic evaluation and financial strength rating frequently increase as a result of formal support agreements. The support evaluation can be improved to a significant degree by a formal support agreement; however, informal support agreements usually have no impact.

Attribute 2: Peer Analysis

SAR performs peer comparisons considering the Business Performance and the Capitalisation, Liquidity and Earnings pillars. The analysis is conducted over the long term to account for the various industry-specific business cycles. This approach ensures consistent outputs using a weighted average approach in scoring each factor under the two pillars to establish the associated ranking order. SAR may drag or lift the issuer's financial strength rating by up to two notches depending on its relative performance metrics.

3. Instrument Ratings

Instrument Ratings

The primary basis for notching, which emphasises contractual subordination, is the debt instrument's seniority in the issuer's capital structure. SAR assesses legal documents because, in the event of bankruptcy, they dictate the distribution of funds to subordinated creditors. The rating of a prior issue may be downgraded if relatively senior subordinated debt is issued in addition to existing subordinated debt, subject to an assessment of loss-absorption features and convertibility to equity or further subordination. Notching is conducted from the issuer's credit rating (ICR).

Type of instrument	Description	Notching
Senior	Contractually senior debt obligations.	ICR - 1
Subordinated	Contractually subordinated debt, without any write-down or non-payment conditions, either mandatory or discretionary.	ICR - 2
Junior	Contractually subordinated debt, with write-down or non-payment conditions, either mandatory or discretionary.	ICR - 3

3.1. Converting Scores into Ratings

Sovereign Africa Ratings (SAR): Converting Scores into Ratings							
	SAR Tier Grade	Points Allocation			Long-Term Issuer Credit Rating	Short-Term Issuer Credit Rating	Financial Strength Ratings (FSR)
Investment Grade BBB- & Higher	1-Exceptional (Prime): ≥ 80%	Tier 1 800+	1	≥800	AAA	A+	AAA
	2-Very Good (High Grade):	Tier 2 700-799	2	767-799	AA+	A	AA+
	70%-79%		3	734-766	AA		AA
			4	700-733	AA-		AA-
	3-Above Average	Tier 3 600-699	5	667-699	A+	A-	A+
	(Upper Medium Grade):		6	634-666	A		A
	60%-69%		7	600-633	A-		A-
	4-Average	Tier 4 500-599	8	567-599	BBB+	B+	BBB+
	(Low Medium Grade):		9	534-566	BBB		BBB
	50%-59		10	500-533	BBB-		BBB-
Speculative Grade BB+ and lower	5-Below Average:	Tier 5 400-499	11	484-499	BB+	B	BB+
	(Non-Investment Grade		12	467-483	BB		BB
	Speculative) 40% -49%		13	451-466	BB-		BB-
			14	434-450	B+	B-	B+
			15	418-433	B		B
			16	400-417	B-		B-
	6-Poor	Tier 6 300-399	17	367-399	CCC+	C	CCC+
	(Substantial Risks):		18	334-366	CCC		CCC
	31%-39%		19	300-333	CCC-		CCC-
	7-Very Poor	Tier 7 200-299	20	267-299	CC+		CC+
	(Extremely Speculative):		21	234-266	CC		CC
	≤ 16%-30%		22	200-233	CC-		CC-
	8-Default: ≤ 15%	Tier 8 0-199	23	0-199	D	D	D

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