

RATING METHODOLOGY

Insurance Companies

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Research, Credit Ratings, Credit Risk Management

INTRODUCTION

Agusto & Co's rating for insurance companies assesses their financial strength and their ability to meet their obligations to policy holders in accordance with the laid down terms of contracts.

Agusto & Co currently provides ratings on insurance companies, on a solicited basis. Our track record in providing independent credit ratings dates back to 1993, when we commenced risk ratings on Nigerian banks. Initially, we rated all the 120 banks in existence in Nigeria at that time on an unsolicited basis. In 1997, we discontinued our unsolicited rating of banks and requested Nigerian banks to solicit an independent risk rating from Agusto & Co. Limited. From 1998, the scope of our rating expanded to include Discount Houses, Insurance Companies, Other Non-bank Financial Institutions, Industrial Companies, Municipal bonds, Funds and Asset Managers.

RATING OBJECTIVES

An Agusto & Co. rating assesses the financial condition of an insurer as well as its ability to meet claims obligations of its policy holders on a timely basis in the short term. It provides an independent opinion on the risks attributable to doing business with the rated institution. The rating doesn't assess the willingness of management to honour obligations or the quality of its' claims handling services. The rating is not an equity opinion and therefore does not assess the ability of the institution to create value for its shareholders. Also an Agusto & Co. rating is not an audit. We are therefore not liable to any third party who relies on our opinions.

Our principal objectives in analysing and rating insurers is to :

- assist the insurer's counterparties and significant clients have a better understanding of the risks attributable to doing business with the insurer;
- contribute to the development of the financial markets by providing independent risk assessments for the purpose of determining the pricing of financial instruments.

Each Insurance Company 's Rating Report contains:

- Background information on the organisation
- Analyses of balance sheets and income statements over the last three years
- Key indicators of financial condition
- Underwriting skills and claims management
- Investment management
- Reinsurance utilisation
- Ownership, management & staff
- A risk rating indicating the date of issuance and the expiry date.

RATING PHILOSOPHY

Our ratings are based upon both quantitative and qualitative factors. We analyse financial condition over a three-year period and assess other issues which we consider necessary before we arrive at a rating for each insurance company using our uniform rating criteria.

Our analysis is based primarily on audited financial statements and other publicly available information. We however recognise that it is difficult to arrive at a meaningful rating without discussing with management and obtaining additional information not ordinarily published. We therefore seek additional information (both historical and forward-looking) from management on issues which are relevant for arriving at a fair rating for the insurance company concerned. All confidential information which we obtain through this process is not published or otherwise disclosed to third parties.

We also recognise that changing circumstances may quickly invalidate a rating which would have been previously valid. We will therefore review our ratings in instances where there are significant subsequent events which may warrant a change in a previous rating. These reviews will be based on both published financial statements and possibly un-audited interim financial statements. The information upon which the rating is based will however be clearly disclosed.

An insurance company's rating may be changed, suspended or withdrawn at any time. However, the reason for the change, suspension or withdrawal is usually communicated to the institution in advance.

The Rating Process

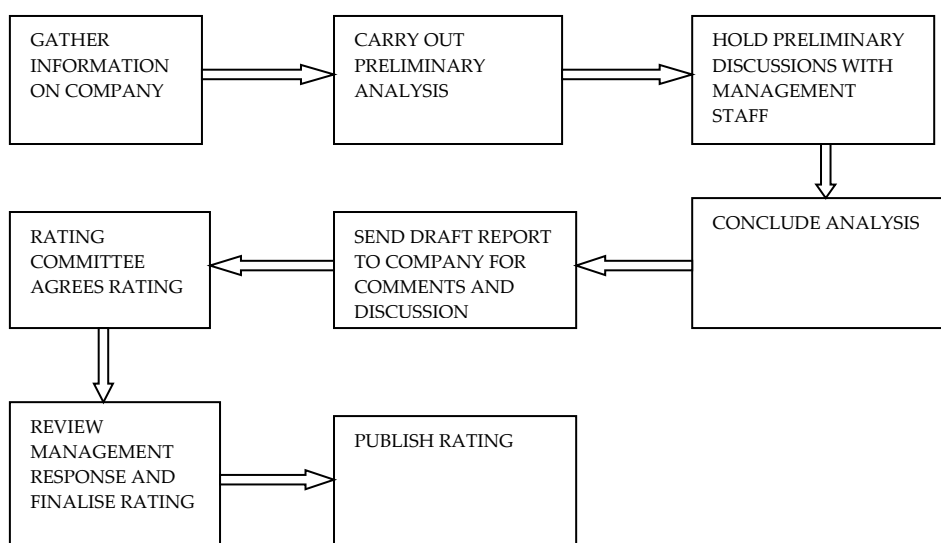


Fig.1: Agusto & Co. Rating Process

In order to arrive at a rating we typically follow the process depicted in fig. 1.

OUR RESPONSIBILITY

The relationship between the rated insurance company and Agusto & Co. Limited is contained in a standard letter of engagement, which is addressed to Agusto & Co. by the institution, which sets out the contractual relationship between the insurance company being rated and the rating agency.

DEFINITION OF RATINGS

Agusto & Co. rating categories conform to internationally recognisable designation for rating categories. A comparison of our rating categories is shown below.

Agusto & Co. Scoring Grid	Agusto & Co.	S & P's equivalent	Moody's equivalent	Fitch's equivalent
Over 89%	Aaa	AAA	Aaa	AAA
80% to 89%	Aa	AA	Aa	AA
70% to 79%	A	A	A	A
60% to 69%	Bbb	BBB	Baa	BBB
50% to 59%	Bb	BB	Ba	BB
40% to 49%	B	B	B	B
Below 40%	C	C	C	C
	D	D		D

Aaa Insurer with impeccable financial condition and the strongest capacity to meet claim obligations.

Aa Insurer with very good financial condition and very strong capacity to meet claim obligations.

A Insurer with good financial condition and Strong capacity to meet claim obligations.

Bbb Insurer with satisfactory financial condition and adequate capacity to meet claim obligations.

Bb Insurer with satisfactory financial condition and uncertain capacity to meet claim obligations.

B Insurer with weak financial condition and poor capacity to meet claim obligations.

C Insurer with very weak financial condition and very poor capacity to meet claim obligations.

D In default.

A "+" (plus) or "-" (minus) sign may be assigned to ratings from Aa to C to reflect comparative position within the rating category. Therefore, a rating with + (plus) attached to it is a notch higher than a rating without the + (plus) sign and two notches higher than a rating with the - (minus) sign.

RATING METHODOLOGY

The typical process that we follow in carrying out a rating is outlined below.

Macro-Economic Analysis

As an integral part of our macro-economic analysis, we review macro-economic trends over the past five years. We also review political issues and how they affect the economy. At the end of the analyses we:

- prepare macro-economic projections for the next five years
- explore alternative political scenarios
- form an opinion on the economic outlook and its impact on the insurance sub-sector and the financial services industry

We then assign a Country Risk Rating to Nigeria.

Industry Analysis

We conduct an in-depth study of the Insurance industry annually. The key areas we review are:

- Size and strategic importance of the industry
- Regulation
- Industry characteristics
- Industry financial condition
- Key success factors
- Major risk areas
- Problems of the industry
- Outlook

At the end of our industry analysis we:

- note industry trends over the past five years
- prepare a five year projection of the financial performance of the industry
- form an opinion on the performance of the insurance sub-sector and financial services industry over the next five years.

We then assign an Industry Risk Rating to the insurance industry.

Insurance Company Analysis

A rating programme is put in place for every insurance company that solicits a rating. This covers a period of one year and includes a detailed annual review of each institution. The annual review is usually timed to coincide with the publication of the audited accounts of the insurance company.

An annual review starts with a provision of the insurance company's financial statement for the last three years and information gathered using our standard questionnaire. Meetings with principal officers of the rated insurance company are another source for relevant information. A draft Rating Report is then prepared on the insurance company being reviewed. This will contain background information on the insurance company and the Analyst's comments on:

- Underwriting expertise
- Capital adequacy & leverage
- Profitability
- Investment management
- Liquidity & Cash flow
- Reinsurance Utilization
- Ownership, management and staff
- Outlook

The draft Rating Report (without a rating) is sent to the management of the insurance company. The Management of this insurance company will communicate to us if the following issues are in the report:

- Factual errors
- any information which they may consider confidential and not in the public domain
- note any opinion(s) expressed in the report which they disagree with and reason(s) for the disagreement.

The corrected Rating Report is then presented to our Rating Committee. The Rating Committee will also be informed of any areas of disagreement.

The Rating Committee then assigns a rating to the insurance company bearing in mind that the objective of the rating is to determine the financial strength of the insurer and its ability to meet obligations to policy holders in accordance with the laid down terms of contracts. It also takes into account macro-economic and industry information at its disposal. The Rating Committee arrives at a rating based on the score of the institution on our model and taking into consideration other relevant information.

The Rating Report (with a rating) is then sent to the insurance company's management. Our analyst(s) will once again meet with the management of the insurance company to discuss

the final report and justify the rating **if required**. Agosto & Co. reserves the right to publish the rating on its website and also circulate to its subscribers.

Monitoring

The rating assigned to an insurance company is monitored throughout its life. Changes in macro-economics, politics, the banking industry and/or the insurance company may make us change an institution's rating. The reason for the change is usually communicated to the insurance company's management.

RATING CRITERIA

To arrive at a rating, we consider both qualitative and quantitative criteria. We have specific benchmarks in the following broad areas which we apply across the board:

Underwriting Expertise

We lay significant emphasis on the underwriting expertise of the insurance company in each of its business lines. Agosto & Co believes that sound underwriting policies are key for the continued existence of an insurer. We also evaluate its claims management and expertise.

- Evaluation of underwriting guidelines
- Underwriting performance using combined ratio
- Business mix
- Controls over third party underwriters
- Claims management

Capital Adequacy & Leverage

Our criteria for determining the adequacy of capital focuses on adherence to regulatory guidelines on capital adequacy and, the measure of degree to which the insurance company's capital is able to absorb possible losses.

- Paid up capital
- Quality of capital
- Insurance funds/net premium
- Solvency margin
- Future capital needs
- Financial flexibility

Profitability

We evaluate an insurer's operating performance over a three year period. Our performance analysis seeks to determine the growth in net premium, funding costs, losses and operating cost profile on the Institutions profitability. In arriving at an opinion on the insurance company's profitability, we employ trend and peer analysis.

- Premium growth rate
- Trend and volatility of earnings
- Major contributors to profitability
- Return on average assets
- Return on average equity
- Underwriting expense ratio
- Operating ratio
- Sustainability of profitability

Investment Management

Agusto & Co. analysis of the insurer's investment portfolio focuses on the credit risk, liquidity risk, market risk and diversification. We look at the investment guidelines and management controls as it pertains to investments. A portfolio of well diversified, liquid and good quality assets puts a non-life insurer in good stead given the short tail nature of most of its liabilities.

- Investment philosophy
- Investment mix
- Credit risk
- Liquidity risk
- Market risk
- Investments in subsidiaries & associates as a % of equity
- Diversification by asset class and industry sector
- Historical investment performance
- Return on Investment
- Maturity structure of assets.

Liquidity & Cashflow

Agusto & Co. analysis of the insurer's liquidity and the degree to which it can meet its financial obligations by cash, liquid assets or through operating cash flow.

- Cash flow from operations
- Operating cash flow/Outstanding claims
- Liquid assets/Insurance funds

- Liquid assets/Outstanding claims
- Asset and Liability Management

Reinsurance Utilization

Agusto & Co assess the insurer's use of reinsurance. Issues considered include over reliance of reinsurance, what is the credit risk of the reinsurance company, why is reinsurance being used and the retention rate of each business class of the insurer.

- Number of reinsurer(s) currently being used by insurance company
- Number of reinsurance programmes it has entered into
- Selection criteria for reinsurer(s)
- Credit quality of reinsurer (s)
- Level of retention for each asset class
- Reasons for changes in retention limits in the last three years
- Reinsurance recoverable/shareholders' funds
- Percentage of premiums (risk) retained relative to percentage received

Ownership Structure

We review the ownership pattern and track record of the owners to ascertain their impact on the insurer's operations and continuity. Strong shareholders are more likely to provide support to the insurer when necessary and may be key to enabling the insurer grow business volumes by providing captive business opportunities.

- Character
- Ownership breadth and significant share holdings

Management & Staff

The insurer's strategic objectives, initiatives and track record of performance are considered key indicators of quality of management. We also focus on the use of modern systems and processes, degree of automation, personnel policies, company culture, training, delegation, succession planning and track record in complying with regulatory requirements.

- Quality of management
- Track record of management
- Breadth
- Ability to adapt to changes in the market
- Strength of brand

- Compliance with regulation
- Earnings per staff

Distribution & Technology

For a life insurance company a wide distribution channel is important to reach its target market.

- Availability of wide distribution channels
- Efficiency of the distribution channels
- Technology to support product delivery

The rating assigned to the insurance company may be downgraded if any of the factors below occur which could have adverse effect on the financial condition of the insurance company. They include and are not limited to:

Management/shareholder conflict

An insurance company will be downgraded if there is open conflict between members of management and/or shareholders and we believe that this may have (or has had) an adverse effect on the insurance company's financial condition.

Significant changes in ownership

We may downgrade an insurance company if there is a significant change in ownership and there are uncertainties about

- (1) the character of the new owners, and/or
- (2) the ability of the new owners to sustain a good track record or turn around an ailing institution.

Watch List

In the event of an outbreak of war, extensive lawsuit, a substantial change in business performance or deviation from an expected trend has occurred or is expected to occur, additional information is necessary to take a rating action. Pending when the additional information is received, the existing rating(s) is/are placed on "**Watch List**". The rating is then upgraded, downgraded or maintained after assessing the impact of any such change.

Other factors

A rating is an opinion on the financial strength of a particular insurance company. This financial strength can be affected by a variety of factors which no one can fully predict at a particular point in time. Accordingly, where any issues come to our notice which we believe will significantly affect the financial condition of an insurance company, or the level of risk inherent in such an institution, we will take such factors into account in arriving at a final rating.

BENEFITS

The benefits of a rating include the following:

- Our Rating Report is a ready reference document on the financial strength of an insurance company. Subscribers can use the Rating Reports to form quick opinions on each insurer, whilst saving the time that detailed analysis would have taken. It is not a substitute for the decision-maker's own analysis but can be used when an immediate decision is required, or to form a preliminary opinion.
- It provides independent information to treasurers, credit risk managers or other persons who have responsibility for setting risk acceptance criteria, setting and reviewing placement lines and monitoring the financial condition of other insurance companies.
- A rating enhances the ability of an insurance company to access the enlarging local currency money market and debt market. This is because most of the key players in these markets rely on our ratings for the purposes of identifying counter-parties and pricing transactions.