WASO'S RATING CRITERIA
FOR
GENERAL INSURANCE

The foundation of WASO rating's interactive credit rating process is an ongoing dialogue with the rated company's management, which is facilitated by WASO rating's primary credit analysts. Each interactively rated entity is assigned to a primary analyst, who is supervised by a team leader. The primary analyst is charged with managing the ongoing relationship with company management and performing the fundamental credit analysis prescribed in WASO rating's rating criteria. It is the primary analyst's responsibility to monitor the financial and non-financial results and significant developments for each rated entity in his/her portfolio. A rating evaluation can be considered any time WASO rating becomes aware of a significant development, regardless of the annual review cycle.

This ongoing monitoring and dialogue with management occurs through formal annual rating meetings, as well as interim discussions on key trends and emerging issues as needed. Management meetings afford WASO rating's analysts the opportunity to review with the company factors that may affect its rating, including strategic goals, financial objectives and management practices. It is during these interactive meetings that a company typically will share information that may be extremely sensitive or proprietary in nature.

The dialogue with management continues throughout the rating process, which is described in more detail below.

1. Compile Information. The rating assessment begins with the compilation of detailed public and proprietary financial information, including annual and quarterly financial statements, regulatory filings, certified actuarial and loss-reserve reports, investment detail and guidelines, reinsurance transactions, annual business plans and Best's Supplemental Rating Questionnaire. The primary credit analyst uses this information to develop a tailored meeting agenda for the annual rating meeting. The annual meeting is a key source of quantitative and qualitative information.

2. Perform Analysis. WASO rating's analytical process incorporates a host of quantitativeand qualitative measures that evaluate various sources of risk to an organization's financial health, including underwriting, credit, interest rate, country and market risks, aswell as economic and regulatory factors. The analysis includes comparisons with peers, industry standards and proprietary benchmarks, as well as assessments of operating plans, philosophy, management, risk appetite, and the implicit or explicit support of a parent or affiliate.

3. Determine WASO's Rating. An initial rating recommendation is developed based on the analytical process outlined above. Each rating recommendation is reviewed and modified, as appropriate, through a rigorous committee process that involves WASO's analysts and senior rating officers who possess relevant expertise. This committee approach ensures consistency of ratings across different business segments and maintains the integrity of the rating process and methodology. The final rating outcome is determined by one or more rating committees after a robust discussion of the pertinent rating issues and financial data. Before public dissemination, the rating outcome is communicated to the company to which it is

being assigned. If the company disagrees with the rating and believes that the information on which it was based was incomplete or misunderstood, then the rating can be appealed. If material new information is forthcoming in a timely manner, then the rating committee may reconsider the rating.

4. Disseminate WASO's Rating. WASO's Credit Ratings are disseminated as soon as practicable once the rating process is finalized. The ratings are made available to the public via WASO rating's website and through a number of different data providers and news vendors.

5. Monitor WASO's Rating. Once an interactive credit rating is published, WASO rating monitors and updates the rating by regularly analyzing the company's creditworthiness. WASO rating's analysts continually monitor current developments (e.g., financial statements, public documents, news events) to evaluate the potential impact on a company's rating. Significant developments can result in an interim rating evaluation, as well as modification of the rating or outlook. The primary analyst typically will initiate an evaluation of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action.

Information Requirements

The primary source of information is each company's annual and quarterly (if available) financial statements, as filed with the regulatory agency of the state, province, territory or country in which the company is domiciled. Other sources of information include, but are not limited to interim management reports on emerging issues; supplemental information requested by WASO rating; information provided through the annual rating meeting and other discussions with management; and information available in the public domain.

WASO rating expects all information submitted by a company to be accurate and complete. Information provided by a company during a rating meeting, or other interim discussions, may be extremely sensitive and/or proprietary. WASO rating analysts are held to the highest standards of ethical and professional conduct in handling such information. WASO has established policies and procedures to prevent unauthorized disclosure of confidential information and ratings before their release. WASO rating allows the use of confidential information only for purposes related to its rating activities or in accordance with any confidentiality agreements with the rated company.

Requested Data Items: Non-life Insurance Companies

1. Annual Reports (Latest Five Years)
2. Audited Financial Statement(s) – Consolidated and Parent Only (Annually)
3. Actuarial Report(s), Both Internal and External, When Available (Annually)
4. Organizational Structure for Parent and Subsidiaries
5. Management Structure, Board of Directors and Key Executive Committees
6. Biographical Information on Principal Officers
7. Strategic Business Plans/Five-Year Projections (Assumptions)/Ownership/ Capital Resources
8. Capital Management Strategies/Investor/Sponsor Strategy
9. Enterprise Risk Management Strategies

10. Competitive Advantages/Disadvantages
11. Completed Best's Supplemental Rating Questionnaire (SRQ) (Annually)
12. Reinsurance Contracts
13. Catastrophe Management Strategies (P/C Companies Only)
14. Key Distribution Partners
15. Company's Investment Guidelines
16. Any Other Information Believed to Be Relevant to the Rating Process

Advance notification, including background information, of significant transactions should be provided to the primary credit analyst. This gives the analyst, and WASO rating's rating committees, an opportunity to evaluate the impact of the transaction on the company's operations, and to render a rating decision in a timely manner, if appropriate. All nonpublic information is considered proprietary, and WASO rating will hold it in strictest confidence.

WASO has been assigning Financial Strength Ratings to insurance companies since February 2012. The ratings assesses an insurance company's ability to meet policy holders obligations. WASO rating methodology for general or non-life insurance companies entails assessing them on a stand-alone basis as well as assessing the level of parent support they receive. On a stand-alone basis,WASO evaluates factors such as industry risk, the business risks across various segments, the insurance company's risk management systems, its goals and strategies and projected business plans, apart from examining its financials. Parent support would be specially crucial for start-up insurance ventures given the need for recapitalization till they break even and begin generating profits.

Overview of WASO Credit Rating Evaluation

The primary objective of WASO Credit Ratings within the insurance segment is to provide an opinion of the rated entity's ability to meet its senior financial obligations, which for an operating insurance company are its ongoing insurance policy and contract obligations. The assignment of an interactive rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile, as compared with WASO rating's quantitative and qualitative standards. In determining a company's ability to meet its current and ongoing obligations, the most important area to evaluate is its balance sheet strength, since it is the foundation for financial security. Balance sheet strength measures the exposure of a company's equity or surplus to volatility based on its operating and financial practices, and can reflect its capital-generation capabilities resulting from quality of earnings. One of the primary tools used to evaluate an insurer's balance sheet strength is WASO's Capital Adequacy Ratio (BCAR), which provides a quantitative measure of the risks inherent in a company's investment and insurance profile, relative to its risk-adjusted capital. WASO rating's analysis of the balance sheet also encompasses a thorough review of various financial tests and ratios over five-year and in some cases 10-year periods. The assessment of balance sheet strength includes an analysis of an organization's regulatory filings at the operating insurance company, holding company and consolidated levels. To assess the financial strength and financial flexibility of a rated entity, a variety of balance sheet, income statement and cash-flow metrics are reviewed, including corporate capital structure, financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical sources and uses of capital. While balance sheet strength is the foundation for financial security, it provides an assessment of capital adequacy at a point in time.

WASO rating views operating performance and business profile as leading indicators when measuring future balance sheet strength and long-term financial stability. The term “future” is the key, since ratings are prospective and go well beyond a “static” balance sheet view. Profitability is the engine that ultimately drives capital, and lookin out into the future enables the analyst to gauge a company’s ability to preserve and/or generate new capital over time. In many respects, what determines the relative strength or weakness of a company’s operating performance is a combination of its business profile and its ability to effectively execute its strategy. A company exhibiting strong performance over time will generate earnings sufficient to maintain a prudent level of risk-adjusted capital and optimize stakeholder value. Strong performers are those companies whose earnings are relatively consistent and deemed to be sustainable. Companies with a stable track record and better than average earnings power may receive higher ratings and have lower risk-adjusted capital relative to their peers. On the other hand, companies that have demonstrated weaknesses in their earnings – through either consistent losses or volatility – are more likely to struggle to maintain or improve capital in the future. For these reasons, these companies typically are rate lower than their counterparts that perform well and usually are held to higher tha minimum capital guidelines to minimize the chance of being downgraded if established trends were to continue.

WASO rating believes that risk management is the common thread that links balance sheet strength, operating performance and business profile. Risk management fundamentals can be found in the strategic decision-making process used by a company to define its business profile, and in the various financial management practices and operating elements of an insurer that dictate the sustainability of its operating performance and, ultimately, its exposure to capital volatility. As such, if a company is practicing sound risk management and executing its strategy effectively, then it will preserve and build its balance sheet strength and perform successfully over the long term both key elements of WASO rating’s and the evaluation of risk management.

Assumptions & Macroeconomic Factors

Based on historical experience and WASO rating’s transition studies, ratings typically move no more than one to two notches when rating action occurs. However, market influences, including macroeconomic conditions, interest rate movements, inflationary levels, volatility of capital markets, pricing levels and regulatory changes, could result in larger scale movement in the ratings.

WASO factors the economic and financial system conditions of a country into all of its ratings. WASO rating defines country risk as the risk that country-specific factors could adversely affect an insurer’s ability to meet its financial obligations, and separates the risks into three main categories: economic risk, political risk and financial system risk.

Economic risk is the likelihood that fundamental weaknesses in a country’s economy will cause adverse developments for an insurer. WASO rating’s assessment of economic risk evaluates the state of the domestic economy, labor market conditions, inflation levels and volatility, as well as prospects for growth and stability. The level of economic risk in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

Financial system risk is separated into two parts, insurance risk and non-insurance financial system risk. Non-insurance risk is the risk that financial volatility may erupt because of inadequate reporting standards, weak banking systems or asset markets, or poor regulatory structure. Non-insurance financial system risk considers a country's banking system, accounting standards and government finances, and it assesses how vulnerable the financial system is to external or internal volatility. Included in this analysis are the performances of banks, equity indices and fixed-income securities, as well as an assessment of the depth and volatility of the country's capital markets. Insurance risk is the risk that the insurance industry's levels of development and public awareness; transparency and effectiveness of regulation; reporting standards; and regulatory sophistication will contribute to a volatile financial system and compromise an insurer's ability to pay claims. The level of financial system risk (combing insurance and non-insurance financial system risk) in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

Political risk is the likelihood that governmental or bureaucratic inefficiencies, societal tensions, an inadequate legal system or international tensions will cause adverse developments for an insurer. Political risk comprises the stability of a government and society; the effectiveness of international diplomatic relationships; the reliability and integrity of the legal system and business infrastructure; the efficiency of the government bureaucracy; and the appropriateness and effectiveness of the government's economic policies. The level of political risk in a country is determined to be: (1) very low; (2) low; (3) moderate; (4) high or (5) very high.

The scores for each category of risk then are aggregated and the country is assigned to one of five Country Risk Tiers with the following broad definitions.

• CRT-1: Predictable and transparent political environment, legal system and business infrastructure; sophisticated financial system regulation with deep capital markets; mature insurance industry framework.
• CRT-2: Predictable and transparent political environment, legal system and business infrastructure; sufficient financial system regulation; mature insurance industry framework.
• CRT-3: Developing political environment, legal system and business infrastructure with developing capital markets; developing insurance regulatory structure.
• CRT-4: Relatively unpredictable and nontransparent political, legal and business environment with underdeveloped capital markets; partially to fully inadequate regulatory structure.
• CRT-5: Unpredictable and opaque political, legal and business environment with limited or nonexistent capital markets; low human development and social instability; nascent insurance industry.

In general, as country risk increases (measured by a higher assigned tier), the distribution of ratings migrates down the rating scale as the level of risk approaches CRT-5 While potential volatility already is contemplated in each Country Risk Tier, unanticipated negative changes to the economic, political and/or financial system conditions could lead to downward pressure on ratings in that country.

Underwriting & Pricing Reserve Adequacy:
Based on WASO rating's internal analysis, overall loss and loss-adjustment expense reserves currently are weakening, particularly in longer tail lines of business. As such, WASO rating's assumption begins with a modest reserve deficiency for ratings

that fall into CRT-1 and CRT-2 tiers. For ratings associated with tiers CRT-3, CRT-4 and CRT-5, additional deficiency is applied in the evaluation of reserves. Deficiency levels can be adjusted based on individual company experience and third-party actuarial reviews.

Pricing Expectations:
WASO rating expects stabilization in pricing to continue across most markets, with more hardening expected in catastrophe-impacted lines of business. Competition remains above average, which continues to place pressure on rates and reserve adequacy. Local market conditions and actual underwriting experience in a given market are considered in the pricing expectations based on where a specific company operates.

Other Factors
Regulatory Changes:
While regulatory changes are not directly tied to the economy, changes may be necessary in response to other factors such as pricing levels and underwriting results. Regulatory changes typically impact selected lines and markets.

Catastrophe Risks:
Recent above-average catastrophe trends are expected to continue over the next 12 months. As a starting point, catastrophe modeling output is utilized in the rating process. WASO rating assumes appropriate data quality is utilized in management's analysis of exposures. Companies are expected to incorporate their catastrophe exposures into their overall risk management programs.

Key Quantitative and Qualitative Rating Factors

The assignment of an interactive Best's Credit Rating involves a comprehensive quantitative and qualitative analysis of a company's balance sheet strength, operating performance and business profile. The interpretation of quantitative measurements involves the incorporation of more qualitative considerations into the process that may impact prospective financial strength. WASO rating's quantitative evaluation is based on an analysis of each company's reported financial performance, utilizing numerous financial tests and supporting data. These tests, which underlie WASO rating's evaluation of balance sheet strength and operating performance, vary in importance depending on a company's characteristics.
A company's quantitative results are compared with industry composites as established by WASO rating. Composite standards are based on the performance of many insurance companies with comparable business mix and organizational structure. In addition, industry composite benchmarks are adjusted from time to time for systemic changes in underwriting, economic and regulatory market conditions to ensure the most effective and appropriate analysis.

1.Balance Sheet Strength
In determining a company's ability to meet its current and ongoing senior obligations, the most important area to evaluate is its balance sheet strength. An analysis of a company's underwriting, financial, operating and asset leverage is very important in assessing its overall balance sheet strength. Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. A highly leveraged or poorly capitalized company can show a high return on equity/surplus, but it may be exposed to a high risk of instability. Conservative

leverage or capitalization enables an insurer to better withstand catastrophes; unexpected losses and adverse changes in underwriting results; fluctuating investment returns or investment losses; and changes in regulatory or economic conditions.

Underwriting leverage is generated from current premium writings, reinsurance and loss or policy reserves. WASO rating reviews these forms of leverage to analyze changes in trends and magnitudes. To measure exposure to pricing errors in a company's book of business, WASO rating reviews the ratio of gross and net premiums written to capital. To measure credit exposure and dependence on reinsurance, WASO rating reviews the credit quality of a company's reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables to surplus. To measure exposure to unpaid obligations, unearned premiums and exposure to reserving errors, WASO rating analyzes the ratio of net liabilities to surplus. To assess whether or not a company's underwriting leverage is prudent, WASO rating considers a number of factors unique to the company, including type of business written; spread of risk; quality and appropriateness of its reins urance program; quality and diversification of assets; and adequacy of loss reserves.

Financial leverage WASO rating reviews a company's financial leverage in conjunction with its underwriting leverage in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt or debt-like instruments (including financial reinsurance) may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis is conducted at both the operating company and holding company levels, if applicable. To supplement its assessment of financial leverage, WASO rating also reviews a company's operating leverage. WASO rating broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. WASO rating has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by WASO rating as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

Asset leverage WASO rating also evaluates asset leverage, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investmen portfolio and the potential impact on its balance sheet strength.

A company's underwriting, financial and asset leverage also are subjected to an evaluation by WASO Capital Adequacy Ratio (CAR), which calculates the net required capital to support the company's underwriting, investment and credit risks. This encompasses the exposure of its investments, assets and underwriting to adverse

economic and market conditions such as a rise in interest rates, decline in the equity markets or above-normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's relative balance sheet strength compared with its operating risks. The CAR is based on audited financial statements and supplemental information provided by companies. The CAR result is an important component in determining a company's balance sheet strength. WASO rating also views insurance groups on a consolidated basis and assigns a common CAR result to group consolidations or multiple member companies that are linked together through inter company pooling or reinsurance arrangements.

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Capitalization Tests for Property/Casualty Companies

• **Change in Net Premiums Written (NPW):** The annual percentage change in net premiums written. A company should demonstrate an ability to support controlled business growth with quality surplus growth from strong internal capital generation.
• **NPW to Policyholders' Surplus (PHS):** The ratio of net premiums written to surplus. This measures the company's exposure to pricing errors in its current book of business.
• **Net Liabilities to PHS:** The ratio of loss reserves and other liabilities to surplus. This measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss-reserve leverage, the more critically a company's solvency depends upon having and maintaining adequate reserves.
• **Net Leverage:** This ratio measures the combination of a company's net exposure to pricing errors in its current book of business and errors of estimation in its net liabilities after reinsurance, in relation to surplus.
• **Ceded Reinsurance Leverage:** This ratio measures the company's dependence upon the security provided by its reinsurers and its potential exposure to adjustments on such reinsurance.

• **Gross Leverage:** This ratio measures a company's gross exposure to pricing errors in its current book of business, to errors of estimating its liabilities, and to its reinsurers.
• **Best's Capital Adequacy Ratio (BCAR):** The BCAR compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks.

Quality and Appropriateness of Reinsurance and Other Risk Mitigation Programs

Reinsurance plays an essential role in the risk-spreading process and provides insurers with varying degrees of financial stability. As a result, WASO rating evaluates a company's reinsurance program to determine its appropriateness and credit quality. A company's reinsurance program should be appropriate relative to its policy limits, underwriting risks and catastrophe exposures. In addition, a reinsurance program should include reinsurers of good credit quality, since in the event of a reinsurer's failure to respond to its share of a loss, the reinsured or counterparty would have to absorb a potentially large loss in its entirety. To be considered adequate for catastrophe protection, a program needs to protect a property/casualty company from impairment or insolvency due to large shock losses from natural or man-made catastrophes. In addition, reinsurance should provide protection from a series of smaller storm losses that do not trigger recovery from a traditional catastrophe reinsurance program. In addition to spreading risk,

reinsurance can be utilized to leverage a company's surplus to enable it to write more business than otherwise would be possible.

Another method of mitigating catastrophe risk is through the issuance of a catastrophe bond, which is a structured debt instrument that transfers risks associated with low-frequency/high-severity events to investors. These instruments typically incorporate either an indemnity trigger (based on an issuing company's actual loss experience) or some form of an index-based, parametric trigger (based on a predefined industry index). WASO rating recognizes that parametric catastrophe bonds come with "basis risk" that must be considered in the financial strength ratings (FSRs) of the companies sponsoring the bond issues. Basis risk, in the context of catastrophe bonds, generally reflects the possibility that a catastrophe bond may not be partially or fully triggered (for covered perils) even when the sponsor of the catastrophe bond has suffered a loss. Through WASO rating's analysis, a determination is made as to how much basis risk is inherent in a catastrophe bond, which determines how much reinsurance credit will be given to the insurance/reinsurance company that sponsors a catastrophe bond with a parametric trigger.

Sidecars are yet another way for insurers/reinsurers to mitigate risk. A sidecar is a limited-life, special-purpose reinsurance vehicle that generally provides property catastrophe quota-share reinsurance exclusively to its sponsor. Sponsors of sidecars generally take reinsurance credit for transferring risks to sidecars. While some sidecars may be capitalized to full aggregate limits, others may not be adequately capitalized to absorb losses that deviate from expectations. When capitalization is inadequate, some of the risk originally assumed to be fully hedged by a sidecar (in the determination of the WASO's FSR of the sponsor) ultimately may be borne by the sponsor. This risk is referred to as "tail risk." WASO rating's analysts will assess tail risk to ensure that the sponsor of a sidecar receives appropriate reinsurance credit.

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Adequacy of Loss/Policy Reserves

For property/casualty companies, reserves play an important role in determining the balance sheet strength and flexibility of an insurance carrier, as well as its underlying profitability. The estimation of ultimate reserve requirements is subject to uncertainty.

Actuaries who certify a company's reserves typically provide management with a range within which loss and loss-adjustment expense reserves are deemed adequate. The range of reserve adequacy estimated by actuaries can be very significant. For casualty oriented insurers, a 25% deficiency in current reserves may exceed policyholders' surplus and, therefore, render them technically insolvent.

For property/casualty companies, WASO rating evaluates reserving trends through its proprietary loss-reserve model to measure any equity imbedded in a company's loss reserves. WASO rating's estimate of a company's ultimate loss reserve position then is discounted to determine an economic loss reserve position. Any difference (deficiency or redundancy) between this economic reserve level and a company's carried loss-reserve level then is applied to WASO rating's proprietary capital adequacy model (CAR). This loss-reserve equity adjustment, which can be sizable for property/casualty insurers, enables WASO rating to "level the playing field" within its rating evaluation and better discriminate between companies that historically have under-reserved and those that have strong loss-reserve positions.

Separately, WASO rating also evaluates a company’s ability to monitor premium adequacy and the degree of uncertainty in loss reserves. If the level of reserve uncertainty exceeds any equity in the reserves, or is considered large in relation to net income and surplus, WASO will require a company to maintain a more conservative capital.

Key Loss Reserve Tests for Property/Casualty Companies

• **Loss and LAE Reserves to Policyholders’ Surplus (PHS):** This ratio measures the trend and magnitude of loss reserves to surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer’s solvency.
• **Development to PHS:** This ratio reflects the degree to which year-end surplus was either overstated or understated in each of the past several years.

Quality and Diversification of Assets

The quality and diversification of assets contribute to a company’s financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The higher the liquidity, diversification and/or quality of the asset portfolio, the less uncertainty there is in the value to be realized upon the sale of an asset and the lesser the likelihood of default. Therefore, a company’s investment guidelines are reviewed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large, single investments that exceed 10% of a company’s total capital. Companies that hold illiquid, undiversified and/or speculative assets and have a significant underwriting exposure to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions can jeopardize policyholders’ surplus.

2. Liquidity

Liquidity measures a company’s ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A company’s liquidity depends on the degree to which it can satisfy its financial obligations, whether by holding cash and investments that are sound, diversified and liquid, or through operating cash flow. A high degree of liquidity enables an insurer to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

To measure a company’s ability to satisfy its financial obligations without having to resort to selling long-term investments or affiliated assets, WASO rating reviews a company’s quick liquidity, which measures the amount of cash and marketable investments that have low exposure to price fluctuations. WASO rating also reviews current liquidity to measure the proportion of a company’s total liabilities that are covered by cash and unaffiliated invested assets. Operational and net cash flows are reviewed since they, by themselves, can meet some liquidity needs, provided cash flows are positive, large and stable relative to cash requirements. Finally, WASO rating evaluates the quality, market value and diversification of assets, particularly the exposure of large, single investments relative to capital.

Key Liquidity Tests for Property/Casualty Companies

• **Quick Liquidity:** The ratio of unaffiliated quick assets to liabilities. Quick assets include cash and short-term investments and a percentage of unaffiliated common stocks and unaffiliated, public, investment-grade bonds. This test measures the proportion of liabilities covered by cash and quickly convertible investments. It indicates a company's ability to meet its maturing obligations without requiring the sale of longterm investments or the borrowing of money.
• **Current Liquidity:** The ratio of total current assets to total liabilities. This test measures the proportion of liabilities covered by cash and unaffiliated holdings, excluding mortgages and real estate.
• **Overall Liquidity:** This ratio indicates a company's ability to cover net liabilities with total assets. This ratio does not address the quality and marketability of premium balances, other receivables, affiliated investments and other assets.
• **Operating Cash Flow:** This test measures a company's ability to meet current obligations through the internal generation of funds from insurance operations. Negative balances may indicate unprofitable underwriting results or low-yielding assets.
• **Non-Investment-Grade Bonds to PHS:** This test measures exposure to non-investment-grade bonds as a percentage of surplus. Generally, non-investment-grade bonds carry higher default and illiquidity risks.

3. Operating Performance

Profitable insurance operations are essential for a company to operate as a going concern. For an insurer to remain viable in the marketplace, it must perpetuate a financially strong balance sheet for its policyholders. When evaluating operating performance, WASO's analysis centers on the stability and sustainability of the company's sources of earnings in relation to the liabilities that the company retains.
WASO rating reviews the components of a company's statutory earnings over the past five years to evaluate the sources of profits and the degree and trend of various profitability measures. Areas reviewed include underwriting, investments, capital gains/losses and total operating earnings, both before and after taxes. Profitability measures are distorted easily by operational changes; therefore, WASO rating reviews the mix and trends of premium volume, investment income, net income and surplus. The structure of the company (stock vs. mutual), the length and nature of its insurance liability risks and how these elements relate to the company's operating mission also are important to evaluating profitability.

The degree of volatility in a company's earnings and the impact this could have on capitalization and balance sheet strength are of particular interest to WASO rating. To supplement the review of profitability, WASO rating analyzes the company's earnings under generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS) and any other regulatory or accounting reporting to understand the company's forms and measurements of profitability. This review generally extends beyond the scope of publicly traded companies, since an increasing number of nonpublic insurers also prepare, monitor and/or manage to GAAP, IFRS or other forms of accounting reporting. WASO rating recognizes that a proper assessment of an insurer's current and prospective profitability may involve a review of multiple accounting forms and results to ascertain the true economic picture.

Key Profitability Tests for Property/Casualty Companies

• **Loss Ratio:** This ratio measures the company's underlying profitability, or loss experience, on its total book of business.
• **Expense Ratio:** This ratio measures the company's operational efficiency in underwriting its book of business.
• **Combined Ratio after Policyholder Dividends:** This ratio measures the company's overall underwriting profitability. A combined ratio of less than 100 indicates the company has reported an underwriting profit.
• **Operating Ratio:** The operating ratio measures a company's overall, pretax operational profitability from underwriting and investment activities. An operating ratio of less than 100 indicates a company is able to generate a profit from its core operations.
• **Pretax ROR (Return on Revenue):** This ratio measures a company's operating profitability and is calculated as pretax operating income divided by net premiums earned.
• **Yield on Invested Assets:** This ratio measures the average return on a company's invested assets before capital gains/losses and income taxes.
• **Change in PHS (Policyholders' Surplus):** This ratio measures the annual change in a company's policyholders' surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.
• **Return on PHS:** This ratio measures a company's efficiency in utilizing its surplus on a total-return basis and is calculated using the overall, after-tax profitability from underwriting and investment activities, including unrealized capital gains.

4. Business Profile

Business profile is a qualitative component of WASO rating's rating evaluation that directly impacts the quantitative measures. An insurer's business profile impacts current and future operating performance and, in turn, long-term financial strength and the company's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the company's mix of business, an insurer's competitive market position, and the depth and experience of its management. Lack of size or growth are not typically considered negative rating factors unless WASO rating believes these issues have a negative influence on the company's prospective operating performance and balance sheet strength.

In addition, business profile issues often increase in importance at WASO rating's highest rating levels. At the "Superior" level, insurers are expected to have strong balance sheets, solid operating performance and stable operating trends. What distinguishes these companies is the strength of their business profile, which typically translates into defensible competitive advantages.

Key Business Profile Tests

Spread of Risk: A company's book of business must be analyzed by line in terms of its geographic, product and distribution diversification. However, the size of a company, measured solely by its premium volume, cannot be used to judge its spread of risk. For life/health companies, the mix of business must be evaluated with respect to the distribution and performance of the underlying assets, as well as a company's susceptibility to economic business cycles or regulatory pressures, such as minimum loss ratios, market conduct regulation, or financial services and health care reform initiatives.

For property/casualty companies, the geographic location and concentration of a book of business can have a great impact on its exposure to catastrophic losses, such as terrorist attacks, hurricanes, tornadoes, windstorms, hail or earthquakes. For property insurers, WASO rating requires a company to perform some degree of natural catastrophe modeling on its book of business.

The geographic location and lines of business written by a company also determine its exposure or vulnerability to regulatory or residual market risks that exist within certain jurisdictions. In addition, the mix of business must be evaluated carefully. Because underwriting experience varies dramatically among lines of business, a company's underwriting risk profile must be reviewed, since high-risk lines with volatile loss experience can impact the financial stability of an insurer, particularly one that is poorly capitalized and/or has poor liquidity.

Revenue Composition: A by-line analysis of net premium volume is important to determine changes in the amount, type, geographic distribution, diversification and volatility of business written by a company, which can have either a beneficial or an adverse effect on its prospective profitability. Underwriting income, investment income, capital gains, asset values and, consequently, surplus can be significantly affected by external changes in economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

Competitive Market Position: Analysis of an insurer's operating strategy and competitive advantages by line is essential to assess a company's ability to respond to competitive market challenges, economic volatility and regulatory change in relation to its book of business. Defensible and sustainable competitive advantages include control over distribution; multiple distribution channels; a low cost structure; effective utilization and leveraging of technology; superior service; strong franchise recognition; a captive market of insureds; easy and inexpensive access to capital; and underwriting expertise within the book of business.

Management: The experience and depth of management are important determinants for achieving success, because the insurance business is based on an underlying foundation of trust and fiscal responsibility. Competitive pressures within virtually every insurance market segment have amplified the importance of management's ability to develop and execute defensible strategic plans. WASO rating's understanding of the operating objectives of a company's management team plays an important role in its qualitative evaluation of a company's current and future operating performance. This is particularly true when a company is undergoing a restructuring to address operational issues or balance sheet problems, or is actively raising capital.

Insurance Market Risk: Insurance market risk reflects the potential financial volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sphere within which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e., financial services reform, health care reform, expansion of alternative markets and integration of health care providers). Insurance market risk can be biased either positively or negatively by a number of company-specific business factors.

Event Risk: Event risk can encompass a variety of sudden or unexpected circumstances that may arise and can impact an insurer's financial strength and its

Best's Rating. When a sudden or unexpected event occurs, WASO rating evaluates the financial and market impact to the insurer. Examples include the potential for major business and distribution disruption associated with significant litigation; the potential for a "run-on the bank" due to a loss of policyholder/distributor confidence; economic collapse; or the enactment of significant legislation. In addition, constraints imposed by regulators in the form of mandated rate rollbacks, extraordinary assessments and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a company. Event risk may include changes in management, ownership, parental commitment or distribution; a legal ruling; or a regulatory development. Finally, event risks also can be influenced by potential regulatory or legislative reforms, economic conditions, interest rate levels and financial market performance, as well as societal changes. For international companies, as well as domestic insurers operating abroad, political climates and sovereignty risks also may have a significant bearing on event risk.

Industry risk*:*

Every aspect of the insurance industry is examined from the importance of the insurance sector to the economy, its size and growth potential (present penetration levels and future growth prospects), entry barriers, cyclicality within the industry, the stability of the underwriting performance as well as the regulatory policies governing the sector. On the regulatory front, WASO examines issues such as pricing freedom, licensing requirements, investment guidelines, accounting norms and solvency ratios company needs to comply with.

Business risk*:*
The analysis of business risk entails an examination of factors that specially influence particular company, such as:

Underwriting policy:
Sound underwriting guidelines are pivotal to an insurance company's long-term solvency. WASO attempts to understand the underwriting policies adopted by a company and its ability to manage risks associated with underwriting. The analysis captures the management's policy with regard to underwriting, which could range from focusing on profitable underwriting backed by superior service and value-added risk management services to offering uneconomic rates merely to grow business volumes.

Business mix:
The analysis would focus on the projected business plan to understand the commitment to prudential underwriting standards. For non-life insurance companies, the overall business risk would be determined by overall business mix comprising insurance for fire , marine, aviation, motor, health and miscellaneous segments. Each these segments has a different risk profile. The Insurance Regulatory Development Authority (IRDA) has prescribed a ranking order for the segments in terms of their relative risk profile, which is as follows:

Business Segment	Risk catagory
Fire	Medium

Engineering	Medium
Rural Insurance	Medium
Marine-Hull	Medium
Marine-Cargo	Medium to High
Health	Medium to High
Liability	Medium to High
Motor	High
Aviation	High

WASO views are broadly in line with this ranking order. WASO assesses the risk profile of the various business segments and their impact on the company’s overall underwriting performance.

Policy on reinsurance:
Reinsurance helps to diversify the underwriting risk among a pool of reinsurance and increases an insurance company’s underwriting capacity. Reinsurance is very critical for non-life companies in managing underwriting capacity. Reinsurance is very critical for non-life companies in managing underwriting risks as it not only enhances the underwriting capacity but also helps to cap the overall loss that could devolve on the primary insurer. WASO assesses the level of risk retained by the insurance company by studying its insurance strategies, the reinsurance and the financial strength and credit profile of the reinsurance companies.

In order to assess the extent the retention, WASO assesses the reinsurance programme for each business segment (quota share treaty, surplus treaty and facultative treaty) with the reinsurers . In addition, the analysis captures the policy regarding sharing of claims in excess of the retention limit. Non-life companies enter in to excess of loss covers (XL covers) and catastrophe excess of loss (cat XL) covers to limit the overall liability that devolves on the primary insurer arising from single events.

Asset management:
A prudent management of the investment portfolio is critical to bolstering an insurance company’s overall performance. Appropriate systems, rudent investment policies and internal controls are important aspects of fund management. WASO examines the insurance company’s investment strategy with regard to credit quality, capital appreciation, long-term safety and easy liquidity. The investment portfolio’s diversity across industries and corporates, and single risk concentration limits are important inputs in determining overall asset quality.

Technology and risk management:
Technology, both to support product delivery and manage risks, is critical to the insurance industry. WASO studies the company’s risk management systems for both monitoring risks and for evolving reinsurance strategies. In terms of risk management, globally, insurance companies offer a range of services that include risk analysis, grading and control, hazard studies, safety audit, risk management training and insurance portfolio analysis. These services help corporate clients comply with statutory requirements, institute unified risk management policies and ensure optimal insurance costs. Insurance companies that are able to offer thse risk management services are in a position to enhance their competitive strengths and grow business volumes.

Financial risk:

For new entrants into the insurance sector, WASO evaluates parameters such as start-up capital, future capital infusion plans in line with business requirements, whether the company's solvency ratio comply with IRDA's stipulations and the adequacy of the solvency margin. The timeframe by which the start-up operations will break even, the liquidity plan to meet policyholder's obligations and the accounting policies adopted are critically examined.

Capitalisation:
IRDA has prescribed a minimum start-up capital of Rs. 1 billion for non-life insurance companies. To ensurance the company's safety and financial health, IRDA has prescribed a required solvency margin(RSM) for non-life insurance companies, which currently is the highest of the following:

- Absolute sum of Tk. 500 million.
- Asum equivalent to 20 percent of the net premium income.
- A sum equivalent to 30 percent of the net incurred claims.

In addition to regulatory compliance, the analysis takes into account the adequacy of the solvency margin projected by start-up companies. The solvency ratio, as measured by the available solvency margin/ required solvency margin, is a function of the growth in business and the actual claims experienced by an insurance company.

In addition to the solvency margin, the inherent risk of the underwriting business is captured by the capitalistion ratio, also referred to as the underwriting exposure. Capitalization level is expressed as net premium written to net worth. The lower the ratio, the less the risk exposure of an insurance company. Financial performance: All new players are expected to report losses in the initial years. The high level of initial establishment expenditure, franchise building costs and distribution costs in setting up the agency network will weaken a company's financial performance in the start-up phase. Although general insurance companies can, through their reinsurance programe, limit their maximum liability arising out of single events, a series of small claims (within the insurance company's retention limits) can affect the underwriting performance and thereby, the overall profitability. Also, the lack of reliable historical data on the claims for each segment and sub-segment complicates the problem of assessing future performance with accuracy. Under such circumstances, WASO takes a conservative view on the claims ratio and estimates the amount of additional capital required under various scenarios. WASO discusses with the management and the promoters , their willingness and ability to infuse additional capital under extreme circumstances.

Liquidity and financial flexibility:

This parameters factors in an insurance company's resource strength and liquidity support available to meet policy holder's obligations. The liquidity position will also be a function of the management's policy of maintaining a treasury portfolio to meet

liquidity demands. The primary sources of liquidity include underwriting cash flows, operating cash flows investment portfolio lquidit.

In addition, the analysis will examine whether the insurance company has cash call facilities from its reinsures to meet large claims. Cash call facilities constitute an additional comfort and a positive feature of the company's overall reinsurance program. Insurance companies are expected to have adequate financial flexibility to meet unforeseen contingencies. A line of credit facility from banks to meet short-term liquidity requirements and capital commitments from promoters are important sources of financial flexibility.

5.Parent support:

Assigning the level of parent support is an important feature of WASO's rating methodology. While evaluating parent support, WASO factors in the economic rationale and moral obligations of the parent towards the insurance venture.

The economic rationale captures the strategic importance of venture, the economic incentive for the to support the venture and current and prospective ownership structures. An assessment of the parent's moral obligation to support the venture captures factors such as management control and the management's stated posture towards the start-up. WASO analyses the promoter's stated posture to support the start-up company on an ongoing basis and under distress scenarios. The parent's financial strength also plays a pivotal role in assessing the overall support that it would extend to the insurance venture.

The key rating drivers thus include the start-up capital, business strategy and future capital infusion plans, the promoter's experience in insurance and asset management businesses and the parental support that would be provided to the venture.