A Risk-Based Supervisory Framework

For the Egyptian Insurance Supervisory Authority

A Guide to Conduct Financial Analysis

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Off-site Supervision – Financial Analysis

The following is a suggested approach to conduct an analysis of statutory financial returns. While not intended to be all-inclusive, the approach serves to highlight some of the key components or variables that should be considered and analysed during a risk assessment process. This approach is part and parcel of the new risk-based supervision model adopted by EISA. It is possible that some of the issues raised below don't currently apply in the context of Egyptian insurance companies. However, as the market mature and domestic companies start adopting international best practices, these issues may become more and more prevalent for EISA.

This approach applies equally to both off-site and on-site review process.

Key Principles in Conducting Financial Analysis

Below are some of the basic principles underlying the suggested approach:

- The exercise of sound judgment in determining which areas to investigate further and how far to probe is key to evaluating risks in a company and is central to the effectiveness of the analysis function.

- The supervisor will have gained sufficient knowledge of the external and internal environments prior to conducting and concluding on the results of the financial analysis. The "environments" refers to the external and internal conditions in which an insurer is operating (see the **Guide on the Knowledge of Business** for more details). For example, a company may be failing a number of early warning tests over and above industry norms; however, this situation may not be necessarily a real concern given the context of the insurer i.e. a young and growing company.

- The supervisor needs to take a holistic approach to understanding the risk profile of the insurer. In other words, the analysis of an insurer's environments should not be limited to a quantitative analysis. Qualitative factors such as the nature of related party transactions, off-balance sheet risks, contagion risks related to the parent company, contractual arrangements between the company and other parties e.g. banks, third party administrators, etc. need to be considered as well.

- The analysis function will be a dynamic and continuous process. Supervisors will be expected to update an insurer's business profile and risk assessment as new information is received, both quantitative and qualitative (see **Risk-Based Framework Documentation** below). This is one of the key success factors to the risk-based supervisory model.

The issues to be considered below are not presented in any particular order of importance.

Risk-Based Framework Documentation

The risk-based framework documentation includes a series of electronic formatted section notes to summarize the analysis of documents and reports. One in particular, the **Monitoring Section Note** (see Appendix A) is used to summarize the analysis and conclusion derived from periodic reviews (usually quarterly or monthly) of the activities of an insurer for both qualitative and quantitative data. The section note is intended to highlight changes and trends that may impact on the insurer's risk assessment and require either supervisory action or further monitoring.

There is a wide variety of information sources including financial statements, statutory returns, actuarial report, rating agencies reviews, internal and external auditor's reports, other third party reviews and reports, media information, meetings and discussions, etc. The following is a suggested approach to conducting financial analysis derived from these reports. While these procedures have been designed for non-life insurance companies, the procedures for life insurance companies are fairly similar.

Review of EISA Company Files

Supervisors will be expected to maintain their knowledge of the insurance industry, its environment and company operations at a workable level in order to properly risk-assess insurance companies. The first step in gaining this level of knowledge is through the review of documentation, correspondence and reports on a company's operations that EISA receives on a regular basis. Reviewing the information on EISA company files is critical to the assessment process. Unfortunately, this step is often overlooked. Given that EISA does not currently have a centralized document management system in place (departments don't share company operations among themselves, and hence, increases the risk that an important piece of information goes missing or simply ignored through the risk assessment process) where documents are stored in one location either in electronic or paper form, supervisors will need to make extra efforts to locate and keep track of the information filed by companies.

Sources of External Information

There is a considerable amount of information available to assist supervisors in analyzing insurance companies and its industry. In addition to internal economic and financial reports being generated internally by some departments, EISA receives a number of economic reports which may contain issues that affect directly or indirectly the insurance industry and its members. In addition, for a fee, rating agencies (A.M. Best, Fitch, Moody's, Standard and Poor and Weiss) produce rating reports on some of the major insurance companies' financial strength and claims paying ability which some of them have operations in Egypt. Rating agencies also produce other types of financial information that may be helpful to supervisors and may be accessible through the internet. In addition to these, there are other sources of information that provide updates about the industry and specific insurers including:

- Best Insurance
- Best Week
- Best Review
- National Underwriter
- Bloomberg Financial
- Individual company Web sites

Reports to the Capital Markets Authority

At this time, there are no publicly traded insurance companies in Egypt. However, this situation may change with the privatization of some of the government owned institutions e.g. Misr Insurance and as new traded public companies start emerging in the market place to take advantage of the underdeveloped insurance market. Publicly traded companies are required to file, on annual basis detailed information, both quantitative and qualitative on their operations with the Capital Market Authorities. This information can be quite useful for the risk assessment process as some of the information contained in those reports may not be available to EISA through its statutory reporting requirements. When appropriate, EISA may consider asking insurers to submit these reports along with the regular statutory filings.

Filing of Quarterly and Annual Financial Statements

As a start, the supervisor needs to confirm whether the company has filed all its statutory financial returns for the period. In the event that some returns remain outstanding after the due date and the company has not notified EISA of a late filing, it is possible that the company is experiencing some difficulties one way or another. The Portfolio Manager (PM) should contact the company and get an update on the situation (late filing penalties may apply). The PM should document his/her findings in the monitoring section note (more detail later about the monitoring section note).

Early Warning Indicators (or tests)

Early warning indicators are one of the tools that help EISA identify insurers that require special attention or a higher priority in the allocation of its resources. A number of early warning indicators are currently being generated as soon as financial returns are filed with EISA. A guide on the interpretation of tests results has been produced to help supervisors in concluding on the results. (The guide contains additional ratios that EISA may consider using in the future.) Supervisors are expected to get familiar with this guide. In addition to comparing the company calculated results to the suggested range of results, the supervisor should compare the company test results with the peer group and industry results. Results that fall outside the suggested ranges may not be necessarily bad by themselves. For example, an increase in surplus or premiums which is larger than the norm could be quite acceptable given the circumstances of the company (e.g. a small and growing company). While the number of test failures will be one of the many factors that should be considered in determining the supervisory plan and level of intervention for a company, supervisors should be mindful that there might be, as noted above circumstances that may justify the results. Having a clear understanding of the internal and external environments is a key success factor in properly concluding on the test results. The **Knowledge of Business Section** Note has been designed for this purpose. The results of the analysis of the early warning indicators should be documented in the **Monitoring Section Note** and summarized in the **Composite Risk Assessment Summary (CRAS).** The **CRAS** is another formatted section note that has been designed to summarize the risk assessment of an insurer (see Appendix B attached).

Investments

1. General Observations

The quality and diversification of assets contributes to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) should be evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The better the liquidity, diversification and/or quality of the assets, the less uncertainty there is in the value to be realized upon their sale and the lesser the likelihood of default. Therefore, a review of a insurer's invested assets should be performed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large single investments (e.g. investments that exceed, say 5% of a company's total capital and surplus). A company that holds illiquid, undiversified and/or speculative assets and has a significant underwriting exposure to volatile lines of business that are vulnerable to unfavourable changes in underwriting and/or economic conditions is a combination that can jeopardize policyholders' surplus.

As competition increases in the insurance market, company management will be pressured to maximize investment yields to compensate for lower profit margin due to pricing competition. Higher investment yields generally involve higher risk. Moving to a higher yield strategy may result in investments with questionable quality or value.

The matching of assets and liabilities is an important investment consideration particularly for non-life insurers. An insurer must manage its investments in such a way to meet its cash outflow demands due to expected and unexpected losses. Poor matching may force the insurer to liquidate long-term investments at a loss to meet current cash needs.

Diversification in a company's investment portfolio is also an important concept and practice to spread the investment risk and reduce the volatility of the investment returns. A high concentration of investment risk in non marketable securities or investments such as real estate increases the risk profile of the portfolio and the value of the investments, particularly during an economic downturn. As a result, supervisors should be concerned with the following four key concepts[1] in reviewing an insurer's investment portfolio:

1. Diversification – by type and issue to prevent investment concentration;

2. Liquidity – the portfolio should be structured in such a way to provide the ability to convert investments into cash to meet liabilities as they become due without having a major impact on earnings due to changes in market conditions;

3. Quality – this is related directly to credit or default risk. The credit risk for the insurance company is directly related to the counter-party's ability to meet its debt obligations. The lower is the quality of the investment, the higher is the probability that the principal and interest will not be repaid on time; and

4. Valuation – in general, investments are valued at cost or amortized cost, common and preferred stocks are the exceptions. However, impairments may occur over the life of the investments hence requiring a write-down to market value.

2. Quality and Diversification of Assets

Supervisors should consider the following:

Did EISA receive the company's most recent investment plan and objectives, including guidelines on quality, maturity and diversification? If not, why not? Is the company following its plan? If not, why not? Does this strategy make sense given the circumstances, context and product lines of the company? Should EISA intervene in the matter?

Is the investment portfolio in compliance with the investment limitations? If not, what is EISA doing in this regard?

Is the investment portfolio adequately diversified to avoid undue concentration of investments by type and issue? For example, are there any portfolio concentration and exposures to connected groups, major industries, geographic and single name exposures? If so, how is the company managing this risk? What is the extent of the exposure? Should EISA take regulatory actions to have the company rectify the situation? If not, why not?

Has there been a shift in the investment portfolio over the last period? If so, was it approved by EISA? (Find out why the shift occurred.) How significant was the shift? Was it planned or was the company reacting to uncontrollable circumstances?

What is the investment short and long term mix? How does the portfolio mix compare in relation to the insurer's liabilities and to its peers?

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[1] NAIC Financial Analysis Handbook 2005-2006, Property/Casualty Edition, pages 49-50.

Is the company carrying foreign denominated bonds or investments in its portfolio? Is the company exposed to foreign exchange exposure? If so, what is the company's strategy to manage this exposure? Does the strategy make sense given the structure of the portfolio and the liabilities? Does EISA need to take regulatory action to force the company to better manage its foreign exchange risk?

Is there a concern with non-investment grade bonds? Why or why not?

Has there been a disagreement on provisions/income recognition between the external auditors and the insurer over the last period? Is EISA doing anything about this situation? If not, why not?

Is there a mortgage portfolio? If so, is the company tracking non-performing loans? What is the company's policy and practice with respect to monitoring these loans? What is the company's performance in managing a loan portfolio? Is there a concern with the book value of these loans? If so, what should EISA do in this regard?

Are there any mortgages owned by the company i.e. not held for investment purposes? Are the loans adequately collateralized? If yes or no, how was this determined? Are those loans for officers, directors, or other affiliates of the insurer? If so, are they any in arrears? How was the book value of these loans determined? Has there been an increase in the book or carrying value of these loans over the last period? Is so, the supervisor should find out what was the cause of this increase. Should EISA consider regulatory action with respect to this portfolio?

Is there a concern with the level of investment in real estate and mortgages given the company's product lines? Why or why not?

Are there any real estate owned (not held for investment purposes)? If so, is there a concern with respect to the carrying value of these?

Is the amount of receivables increasing (other than receivables from reinsurers), particularly related to agents and brokers balances? Is the trend alarming? How does the amount in relation to total assets compare to peers? How much of these receivables are unlikely to be collected (consider investigating)? What is the company's practice with respect to doubtful accounts? (The receivables should be reported net of provision for doubtful accounts.)

Is there any concern with respect to other asset categories? Has there been an adjustment to the carrying value of these assets over the last period? If so, how significant was the adjustment? What was the reason for the adjustment? Should EISA consider taking regulatory action in this regard?

Is there any asset category or portfolio held and/or managed by a third party administrator? If so, is this according to the strategic plan? Is this portfolio growing? What about contagion risk in the event that something was to go terribly wrong with the third party administrator? Should EISA be concerned with this arrangement(s), particularly with respect to transferring these investments to another administrator? If so, what should EISA do in this regard?

Is the insurer holding any assets outside Egypt directly e.g. real estate or indirectly through a foreign financial institution? If not, how do you know that for sure? If so, was this approved by EISA? (Given that EISA approves every investment purchase and sale, it is unlikely that this is an issue, at least for now.)

Has the company sold any investment towards the end of the period or year? If so, what was the reason for this sale? Should EISA take any action is this regard? (The company may be manipulating the results on its balance sheet and income statement by moving assets in and out and realizing on capital gains to hide underperformance of some asset categories or underwriting results. This behaviour could possibly create a maturity mismatch between its assets and liabilities which may have far reaching consequences in the future, hence increasing the risk profile of the insurer.)

Is there any concern with respect to the way the company accounts for its gains and losses on the sale of investments? Why or why not? What should EISA do in this regard?

Is the company capitalizing any of its expenses including acquisition expenses? How significant is this practice and how does it compare to its peers? Are these expenses considered as non-admitted assets for solvency test purposes? If not, why not? (This issue may not apply to Egypt at this time.)

Conclusion - is the investment portfolio adequately diversified to avoid undue concentration by investment type or issue? Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? Conclude on and document your findings in the **Monitoring and Investment Section Notes**, and summarize the results of your analysis in the **CRAS**.

3. Pledged assets

Pledged assets are assets on which an insurer has granted a security interest. A security interest may be created in many ways, including providing deposits against reinsurance obligations, mortgaging real estate, and lending securities. By giving secured parties first claim against an insurer's assets, pledging affects the realization of assets for the benefit of policyholders.

Supervisors should consider the following:

Are you aware of the insurer pledging any of its assets? If not, how do you know that for sure (consider investigating the issue)? If so, how significant is the pledging? Are those assets deducted from capital for solvency testing purposes? If not, why not?

Liquidity

One of the primary regulatory concerns related to a company's liquidity is the generation of a significant negative cash flow over a prolong period of time. Eventually, the company will be required to take drastic measures which could have a negative impact on the surplus, and ultimately the safety and soundness of the company. Another concern is the evaluation of the liquidity position of the company in terms of its ability to meet future liabilities.

Investment in real estate and mortgage loans is less liquid than many other types of investments. In addition, the supervisor may be concerned with the fair value of the real estate or the underlying collateral of the mortgage loan either due to change in the value of the property or cash flows being generated from the investment. The supervisor may consider conducting a thorough review of the real estate and mortgages portfolios if the market conditions have deteriorated significantly over the last four quarters.

Below are some of the issues that should be considered in reviewing the cash flow and liquidity of an insurer.

Given the company's product lines, is the company's liquidity position matched; short, medium and long term? If not, what is the company's strategy to limit the impact on earnings as a result of market changes or unexpected events or claims? How does the company's liquidity position compare to its peers? Is there any significant concern with respect to the company's liquidity or cash flows? Is this a new issue for the company, or has it been a recurring problem for the past few years? (The supervisor should consider conducting a review of the quality and maturity distribution of the investment portfolio to determine whether the insurer's portfolio appears reasonable based on the types of business written and the composition of the liabilities. If the prior period's net cash from operations was negative, consider having an actuary perform a cash flow analysis.)

Conclusion - Conclude on and document your findings in the **Monitoring and, Assets and Liabilities Management Section Notes**. Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? If so, make sure these are summarized in the CRAS.

Reinsurance

Reinsurance plays an essential role in the risk spreading process and provides insurers with varying degrees of financial stability. A company's reinsurance program should be adequate relative to its policy limits and underwriting risks, catastrophe exposures, business, financial capacity and credit quality of the reinsurers involved. In addition, a reinsurance program should involve timely risk transfer and 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.

An insurer's ability to meet its financial obligations can become overly dependent upon the performance of its reinsurers. A company can also become exposed to the state of reinsurance markets in general. A significant dependency on reinsurance can become problematic if a major reinsurer of the company becomes insolvent or disputes coverage for claims. It also can become a problem if general reinsurance rates, capacity, terms and conditions change dramatically following an industry event. The more a company is dependent upon reinsurance, the more vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater this dependency, the greater the company's reinsurance program should be scrutinized to determine its appropriateness and credit quality and whether it is temporary or permanent in nature.

Supervisors should consider the following:

Is there an effective formal evaluation process that provides for an objective analysis and assessment of reinsurance arrangements on an ongoing basis, taking into account policies and corporate objectives? If yes, has anything unusual emerged through financial reporting over the last period? Is the company doing anything about this new situation? If no, how do you know whether the reinsurance program is getting the proper attention from senior management?

Is the company reinsuring with its affiliates or parents i.e. inter-company pooling? If so, how significant is the risk transfer to this pool? Can this be monitored through regular financial reporting? If not, when was the last time this pooling arrangement was reviewed? Did EISA find any significant concern? If so, what kind of action did the company take to alleviate EISA’s concern? (Reinsurance transactions between affiliated insurance companies do not reduce risk for the group but instead shift risks among affiliates. EISA needs to have a reasonably good understanding of these sorts of arrangements in order to adequately assess the inherent risk in the reinsurance program.)

Has EISA ever discover irregularities in the accounting for reinsurance e.g. the way the company takes credit for disputed accounts? If yes, what was the nature of the irregularities e.g. the way the insurer account for the credits or reductions in the reserves for losses? Can this be monitored through regular financial reporting? If not, make sure this issue is covered during the on-site work.

What is the reinsurer retention level? Has this changed over the last period? If yes, is this according to plans? If not, what has caused the retention level to shift? Does this raise concern for EISA? If yes, what is EISA doing about it?

Is the insurer fronting any of its business for another insurer i.e. ceding most of the business to the reinsurer? Is this according to plans? If so, how significant is the book of business being fronted? Is the company making any money out of this arrangement? Can this book of business be monitored through regular financial reporting? Is this book of business growing? What kind of risks is being transferred? (The company may be under the impression that it will not have to pay all of the resulting losses. In fact, the insurer could overexpose itself if it has no control over the quality of the business being written. Ultimately, regardless of what happened to the reinsurer or the book of business, the direct writer is still liable to settle claims as they become due.)

Are there any overdue or disputed accounts in recoverable from reinsurers? How significant are these amounts? Could these amounts become uncollectible at some point in the future? If so, what is the company doing about it e.g. setting up provisions for doubtful recoverables? Are you noticing an increasing trend in the amount of recoverables? Should EISA intervene in the situation?

Has the company changed its reinsurance program or reinsurer(s) over the last period? Should EISA be concerned with the new program or reinsurer(s)? If so, what does the company need to do to alleviate EISA's concerns? Have these been raised with the insurer? What was there response? Does EISA need to take regulatory action to address the situation? How soon?

Has there been any unusual reinsurance transaction completed during the period? If so, how significant was the transaction? If significant, consider investigating to determine whether the resulting effect of this transaction increases the risk profile of the insurer?

Has the credit-worthiness or solvency position of the reinsurers changed over the last period? If so, how significant was the change? Is the company aware of this change? If not, EISA should consider contacting the insurer to raise this issue.

Conclusion - Conclude on and document your findings in the **Monitoring and Reinsurance Section Notes**. Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? If so, make sure these are summarized in the CRAS.

Claims (Unpaid Losses Reported and Unreported) and Lost Adjustment Expenses Reserves

Unpaid losses 'reported but unpaid' and 'incurred but not reported' (IBNR) are difficult to estimate and are highly subjective, particularly the IBNR. Along with unpaid loss adjustment expenses (LAE)[2] reserve, when combined, these by far represent the largest reported liability by most non-life insurance companies. Most regulators would require the insurer to estimate what the value of its claims will be when they are ultimately settled. Some jurisdictions around the world allow the discounting of certain types of claims, but other than that the insurer is required to create a reserve for every dollar of unpaid claims and related expenses. These reserves are to be reported net of reinsurance.

EISA's primary concern should be that the reserves established by the insurer are sufficient to cover the future costs of settling all of the claims which have occurred as of the financial statement date. A shortfall in the reserves estimate will affect directly the capital and surplus of the company and ultimately its solvency position. As a result, the reserves for unpaid losses and LAE should be monitored closely.

[2] Including claims adjustment expenses, legal fees, court costs, investigation fees, claims processing and payment expenses

Supervisors should consider the following:

Is there a concern with regard to the insurer using the anticipated salvage and subrogation value estimates to reduce the unpaid losses and LAE reserves? Is this an allowed practice? How do you know that for sure? (Some insurers may be able to estimate with some level of accuracy the salvage and subrogation (i.e. the legal right to recover from a third party) values related to a paid claim. If that is the case, this amount should be disclosed by the insurer to EISA.)

Has there been a significant change (e.g. >50%) in unpaid and incurred losses and LAE reserves over the last two years? If so, what are the reasons? Is this an indication of the need to strengthen the IBNR and LAE reserves? Is the growth in reserves to surplus ratio (period end reserves less beginning reserves divided by prior year surplus) greater than 20 percent? If so, consider reviewing the five-year historical data to identify adverse trend or fluctuation.

Is the company discounting any of its claims? If so, what is the rationale for doing so? What interest rates are being used to discount the reserves? What is the rationale for using these rates? Are the rates reasonable? Is discounting of reserves allowed under the current regulatory regime? If not, how do you know the company is not doing it for sure? (This issue should be investigated in particular with companies that issue long-tail liability lines such as medical malpractice. The supervisor should review the one-year and two-year development data on incurred losses to determine which lines of business are developing adverse experience. If incurred loss and LAE reserve development or loss ratios appear unusual, they should be compared to industry and peer averages to determine the reasonableness of the insurer's reserves for incurred losses and LAE[3].)

Have there been any unusual fluctuations in payments pattern related to claims by line of business over the last quarter or the last year? If so, the supervisor should consider performing a loss reserve analysis on the more volatile lines of business such as long-tail lines. (In doing his/her analysis, the supervisor should be mindful of the effect on the unpaid loss and LAE reserves of a change in product design, pricing and claim payments practices. If there are significant concerns resulting from the loss reserve analysis, the supervisor should consider having an actuary review the analysis performed[4].)

Has there been a shift in the company's business from short-tail to long-tail liability lines over the last four quarters? If so, is this according to plans? How is this going to affect the company's incurred loss and LAE reserves? Test for a possible reserve deficiency in the current book of business. What is your conclusion? Should EISA take regulatory action to force the company to strengthen the incurred loss and LAE reserves?

Has there been any change in business practices that could have affected one way or another the reserve estimate related to incurred loss and LAE reserves e.g. significant events, coverage, retention, accounting changes, etc.?

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[3] Source: 2005-06 NAIC Financial Analysis Handbook

[4] Source: 2005-06 NAIC Financial Analysis Handbook

Conclusion - Conclude on and document your findings in the **Monitoring Section Note and Actuarial Section Note**. Are the unpaid loss and LAE reserves adequate given the context (size, complexity and risk profile) of the insurer? Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? If so, make sure these are summarized in the CRAS.

Capital and Shareholders' Equity (Surplus)

In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its 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 surplus, but may be exposed to a high risk of instability. A conservative level of 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.

Surplus is a source of financial support to protect an insurer against unexpected losses, and is, therefore, a key contributor to its safety and soundness. Surplus management is the on-going process of raising and maintaining capital at levels sufficient to support planned operations.

The quality of capital is categorized by its permanence and freedom from mandatory fixed charges against earnings. The adequacy of the quality of capital is assessed against the minimum regulatory requirements. Supervisors should also explain any material changes/trends in the quality of capital from prior years.

In addition, supervisors should document their assessment of the insurer's ability to access capital. This could be from the market and/or parent. An insurer's ability to raise capital in the markets is affected by its own performance and share value, interest rates, rating agency assessments, and any number of factors arising from the general economic climate, including investor attitudes. In the case of domestic insurer owned by a foreign parent, the ability of the parent to provide quality capital support is key in the assessment.

Supervisors should consider the following:

Has there been a change of ownership of the insurer over the last period? If so, how does that affect the risk profile of the insurer?

Has new capital been injected in the insurer over the last period? Is so, was this as a result of a request made by EISA? If not, was EISA informed of the company's intention before the capital was actually injected? What was the company justification for increasing its capital base? Was this according to plans?

Is the level of capital adequate in relation to regulatory minimum requirements? If not, what is the company doing about this situation? Has EISA taken any regulatory action against the company? What has been the result of this intervention?

Is the level of capital adequate to support the current and future business activities? If not, how much more capital does the company need to get in order to prevent its capital from dropping below the minimum capital requirements on an ongoing basis? Do you believe that the shareholder is willing and capable to assist the insurer in maintaining its regulatory capital over and above the minimum requirements? How soon does the company need to raise this new capital?

Are the types and mix of capital instruments and the level of high quality capital i.e. common shares adequate given the nature, complexity and risk profile of the insurer? If not, what would the company need to do to rectify the situation? Has EISA taken any regulatory action to have the company rectify this situation? If not, why not?

Has there been a significant shift (> +/- 20%) in surplus over the last four quarters? What was the reason for this shift? Is this a one time adjustment or do you expect this trend to continue? If you expect this trend to continue, what is the company doing about it? Are you satisfied with the company's action? If not, should EISA impose directives on the company e.g. increase capital, reduce the rate of growth in business, etc.?

Has there been a transfer of business (sale or purchase other than transfer of risks to reinsurers) over the last period? Was EISA informed of this transfer before it took place? How large was the transfer? How was this transfer accounted for in the balance sheet and income statement? How is this transfer affecting the risk profile of the insurer? Is there a need for EISA to follow up on this transfer?

Has the company paid dividends to its shareholders over the last quarters? Was this dividend approved by EISA? Is the company in a weaker solvency position as a result of paying dividends? If so, EISA should consider raising its concerns in this regard with the board and senior management of the company?

Conclusion - Supervisors should document their assessment of the quality of the insurer's surplus in the **Monitoring Section Note and Capital Section Note**. Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? If so, make sure these are summarized in the CRAS.

Earnings

Earnings absorb normal and expected losses in a given period and provide a source of financial support by contributing to the insurer's internal generation of capital and its ability to access capital externally.

An analysis of current performance and historical trends provides the base information needed for assessing an insurer's earnings. Supervisors should document their assessment of historical trends and level of earnings in the **Earnings Section Note**.

Supervisors should document the analysis and assessment of earnings composition by major sources and types. Different sources and types of earnings will differ in quality and susceptibility to external factors, which will affect the degree to which they are stable and sustainable from one period to another. Normally, volatile sources are higher risk and lower quality. Non-recurring sources of earnings are not sustainable and should be identified in the analysis.

A comparison of the insurer's earnings record to the earnings record of a group of its peers, using key indicators, can be helpful in assessing the strength of earnings. The value in peer comparison is in understanding the underlying reasons for the differences such as business objectives, business mix and underlying risk factors, as well as the quality of risk management.

Supervisors should consider the following:

How volatile has net income been over the four running periods? Check earnings by line of business. If there has been a significant shift (+/-) in earnings, what seems to be the main reasons? To which extent earnings are from non-recurring sources of income? If significant, find out what generated this source of income? Should EISA follow-up on this issue? If not, why not?

Has there been a change in actuarial or accounting practices to enhance earnings over the last period? If so, what was the nature of and rationale for the change? Should EISA follow-up on this change?

Is the change in net premiums over the last period within a normal range i.e. -10% to +30%? If not, what was the cause of the unusual result? Should EISA be concerned about the change in premiums?

Has the company entered into new lines of business? If so, is this according to plans? Significant increases or decreases in premiums written may indicate a lack of stability in the insurer's operations. (Consider reviewing changes in the volume of premiums by lines of business to determine which lines of business have increased or decreased significantly and whether any new lines of business are being written. This is particularly important where the insurer writes primarily long-tail liability. 'An insurer that writes primarily short-tail property lines may be able to write at higher levels of premiums to surplus that an insurer that writes primarily long-tail liability lines because the risk of under-pricing and significant adverse underwriting results is less with the short-tail property lines of business'[5]. The supervisor should consider comparing the ratios of gross premiums to surplus and net premiums to surplus to industry and peer averages to help evaluate the insurer's leverage. A net premiums to surplus ratio greater than 200 percent

[5] Source: 2005-06 NAIC Financial Analysis Handbook, p. 73

(>400 percent for gross premiums to surplus) may also indicate that the insurer is over-leveraged and lacks sufficient surplus to finance the business currently being written.)

Confirm whether the insurer is authorized to write all lines of business. If new lines of business are being written, determine whether the insurer has the expertise in the new lines of business or new territories. (This would include expertise in distribution, underwriting, claims and reserving. While there may be no information in the financial returns in this regard, the supervisor may consider contacting the insurer to ascertain to a reasonable level that the insurer can manage these new risks adequately. If the supervisor is not satisfied with the insurer's expertise level after his/her discussion with the insurer, EISA should consider restricting the rate of growth in these new lines of business until the insurer can prove that it can manage these new risks adequately.)

Check the growth in underwriting and other expenses. Is the allocation of expenses across lines of business an issue, particularly with respect to participating (profit) policies? Check trends by lines of business and compare to industry and peer averages. Supervisor should consider reviewing the allocation of expense groups among lines of business, if the information is available i.e. loss adjustment expense (acquisition, field supervision and collection expenses), general expenses, taxes, licenses and fees, and investment expenses

In addition, consider reviewing trends over the last three years of the following ratios. Compare results to industry and peer averages; explain significant deviations from the norm:

- Combined ratio (underwriting performance)
- Loss ratios by lines of business
- Expense ratios and commission ratios by lines of business
- Investment yield ratios (if not satisfactory, check the level of underperforming assets)

Is the company outsourcing any of its functions and/or services such as underwriting, investment counselling, administration, claims handling and/or other related services? Is so, how much fees are being paid to these management services companies? Are the fees considered reasonable considering the services provided? Is there a relationship either directly or indirectly between any of the senior managers and these management services companies? Is so, this relationship should be investigated thoroughly to ensure the fees charged by the management services company are at market rates and that services are actually being provided as per contractual arrangements.

Conclusion - Are the earnings satisfactory? Is the insurer producing returns that will ensure its long term viability without having to rely on non-recurring sources of income to enhance earnings? Although there might be some exposure to earnings volatility, is the outlook for the next 12 months positive? If not, should EISA intervene? Conclude on and document your findings in the **Monitoring Section Note and Earnings Section Note.** Are there any recommendations that could affect the company's on-going supervision plan and/or the on-site plan? If so, make sure these are summarized in the CRAS.

APPENDIX A

INSURER:	INSURANCE CO.
STATEMENT PERIOD:	
SECTION:	MONITORING – QUARTERLY AND ANNUAL RETURNS

DESCRIPTION	
THIS FIRST PAGE IS USED TO CROSS-INDEX DOCUMENTS THAT CONTAIN MORE DETAILED ANALYSIS OF THE OBSERVATIONS NOTED IN THIS SECTION NOTE. HERE ARE SOME EXAMPLES:	
SALES OF ASSETS	
QUARTERLY AND ANNUAL RETURNS	
MINUTES	
ETC.	

SECTION NOTES

INSURER:			
STATEMENT PERIOD:			
SECTION:	MONITORING – PERIOD		
PREPARED/UPDATED BY:		**DATE:**	
REVIEWED BY:		**DATE:**	

REFERENCE:

SIGNIFICANT DEVELOPMENTS/ISSUES/CONCERNS

FINANCIAL HIGHLIGHTS:

ACCOUNTS	THIS PERIOD	LAST PERIOD	% CHANGE
TOTAL ASSETS			
LIQUID ASSETS [6]			
LIFE RESERVES[7]			
NON LIFE RESERVES[8]			
SHAREHOLDERS' EQUITY			
NET PREMIUMS			
NET CLAIMS			
NET INCOME (LOSS)			
SOLVENCY MARGIN			

OBSERVATIONS :

EARLY WARNING INDICATORS RESULTS:

HOW MANY TESTS FALL OUTSIDE THE NORMAL RANGES OR BENCHMARKS?

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[6] Cash, fixed deposits and government bonds

[7] Including IBNR and other Reserves related to product lines

[8] Including IBNR and other Reserves related to product lines

SHOULD EISA BE CONCERNED ABOUT ANY TEST FAILURE? IF SO, WHICH ONE AND WHY?

HOW DOES THE RESULTS AFFECT THE RISK PROFILE OF THE COMPANY?

CONCLUSIONS AND RECOMMENDATIONS

APPENDIX B

SUPERVISORY FILE

INSURER:	
STATEMENT PERIOD:	
SECTION:	**COMPOSITE RISK ASSESSMENT SUMMARY**

DESCRIPTION	
THIS PAGE IS USED TO CROSS-INDEX DOCUMENTS THAT CONTAIN MORE DETAILED ANALYSIS OF THE OBSERVATIONS NOTED IN THIS SECTION NOTE. HERE ARE SOME EXAMPLES:	
CORPORATE ORGANIZATION CHART	
SENIOR MANAGEMENT ORGANIZATION CHART	
MONITORING	
REINSURANCE	
BUSINESS LINES - GENERAL	
ETC.	

COMPOSITE RISK ASSESSMENT SUMMARY

INSURER NAME (#):	
DIRECTOR:	
PORTFOLIO MANAGER:	**DATE OF LAST ON-SITE REVIEW:**
PREPARED/ UPDATED BY:	**DATE:**
REVIEWED BY:	**DATE:**

Risk AssesSment Summary

SUPERVISORY GUIDE CLASSIFICATION:

COMPOSITE RISK RATING:

	High, Above Average, Moderate or Low	Direction	Time frame
COMPOSITE RISK RATING (Appendix 1)			
OVERALL NET RISK RATING			

Composite Risk Rating:

Overall Net Risk Rating:

Business Profile and Strategic Direction

Business Profile and Philosophies

Financial Performance (Earnings)

Strategic Direction and Future Outlook

Significant Recent Developments

Summary of Significant Activities and Related Risks identified

1)
2)

Capital

Overall Quality of Risk Management Control Functions

Overall Effectiveness Rating	Rating	Direction	Date Assessed
Financial Analysis			
Compliance			
Internal Audit/Self-Assessment			
Risk Management			
Senior Management			
Board of Directors and Committees			

Financial Analysis

Compliance

Internal Audi/Self-Assessment

Risk Management

Senior Management

Board of Directors and Committees

Board of Directors

Audit Committee

Conduct Review Committee

Specialist Support
e.g. credit, actuarial specialists

Parent/Home Office Operations

Primary/Other Significant Regulators

Significant Events
(Include results of review of quarterly returns)

Quarter 1

Quarter 2

Quarter 3

Quarter 4

Other Corporate Information

Company Contact/Mailing Address	
External Auditors	
Valuation Actuary (External/In-House)	

Significant Related Parties

Insurer	Portfolio Manager (If applicable.)
Regulated	
Other	

COMPOSITE RISK RATING APPROVAL

RECOMMENDED	Portfolio Manager	Date
	Manager	Date

INSURER NAME RISK MATRIX as at DATE																	
Significant Activities ***(Date of Last In-Depth Assessment)***	***Materiality***	***Inherent Risks*** [9]							***Quality of Risk Management*** [1]							***Net Risk*** [1]	***Direction of Risk*** [1]
		Credit	***Market***	***Liquidity***	***Insurance***	***Operational***	***Legal & Regulatory***	***Strategic***	***Operational***	***Financial***	***Compliance***	***Internal Audit***	***Risk Management***	***Senior Management***	***Board***		

Capital [1]		**Earnings** [1]			
Composite Rating [1]		**Direction of Risk** [1]		**Time Frame**	

Stage Rating	

Note:

For *Inherent Risk, Net Risk* and *Composite Risk*: "H" = High; "AA" = Above Average; "M" = Moderate; "L" = Low

For *Quality of Risk Management, Capital* and *Earnings*: "S" = Strong; "A" = Acceptable; "NI" = Needs Improvement; "W" = Weak

For *Direction of Risk*: "I" = Increasing; "S" = Stable; "D" = Decreasing

Stage Ratings: "1" – No Problems / Normal activities; "2" – Early Warning; "3" – Risk to Financial Viability or Solvency; "4" – Future Financial Viability in Serious Doubt; "5" – Company Not Viable / Insolvency Imminent

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[9] Where there is a change in any rating or the direction of a rating recorded on the Risk Matrix, the revised rating or the direction should be added to the appropriate cell of the Matrix, and the previous rating or direction placed next to it in brackets ("( )"). The comparative ratings should only be included until the next update of the Risk Matrix. This will ensure that only ratings that are changed in a given period are highlighted in this manner.

HISTORICAL RECORD OF REVIEW OF SIGNIFICANT ACTIVITIES

INSURER Name

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
SIGNIFICANT ACTIVITY											

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
QUALITY OF RISK MANAGEMENT											
Financial Analysis											
Compliance											
Internal Audit/ Self-Assessment											
Risk Management											
Senior Management											
Board of Directors											
CAPITAL											
EARNINGS											

For each significant activity for a given year indicate	
The net risk rating	L=Low, M=Moderate; AA=Above Average; H=High
Extent of work done	L=Limited; M=Moderate; I=In depth review
P = Planned where work is planned for the coming year (see first item for example indicating **H**igh risk/**I**n-depth review and (**P**) for work planned in the next year).	

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