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A Risk-Based Supervisory Framework (RBS)

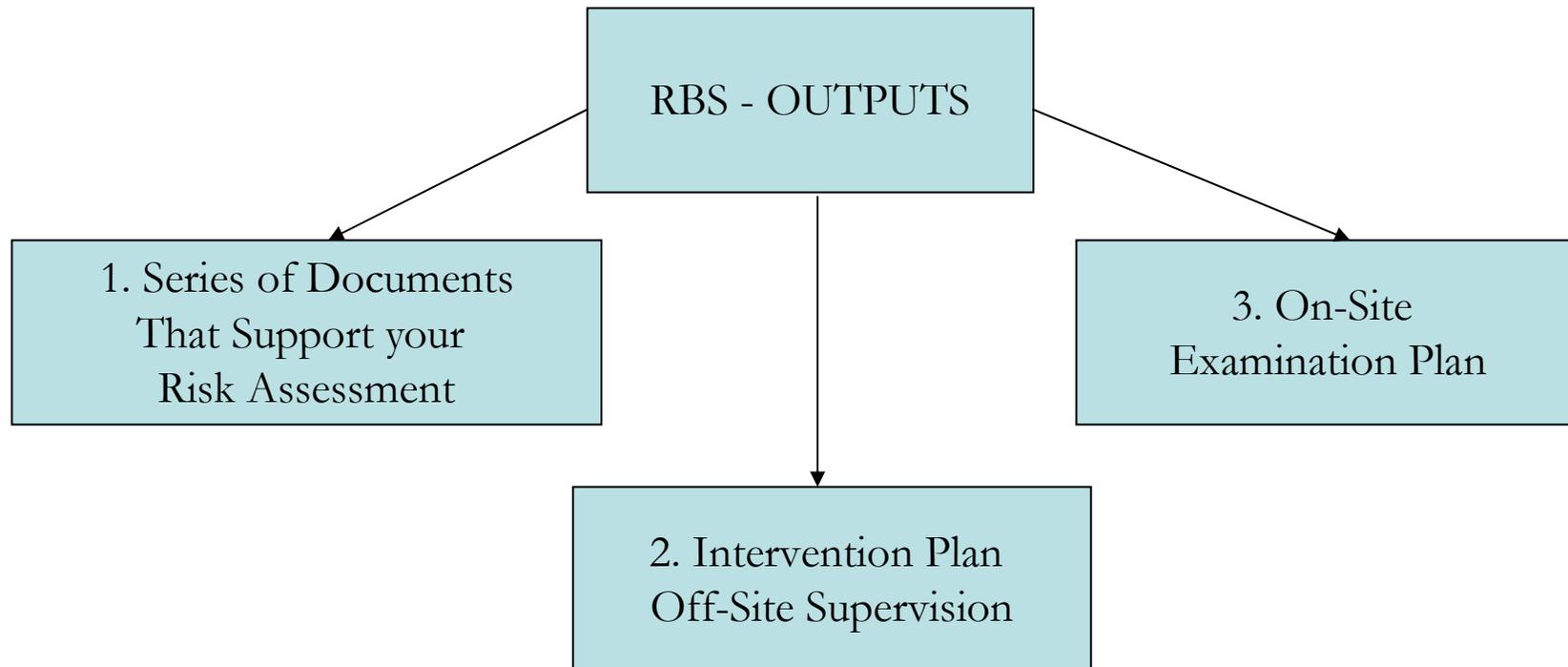
A Guide to Conduct Financial Analysis

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Risk-Based Framework - Outputs





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Financial Analysis – Where do I Start?

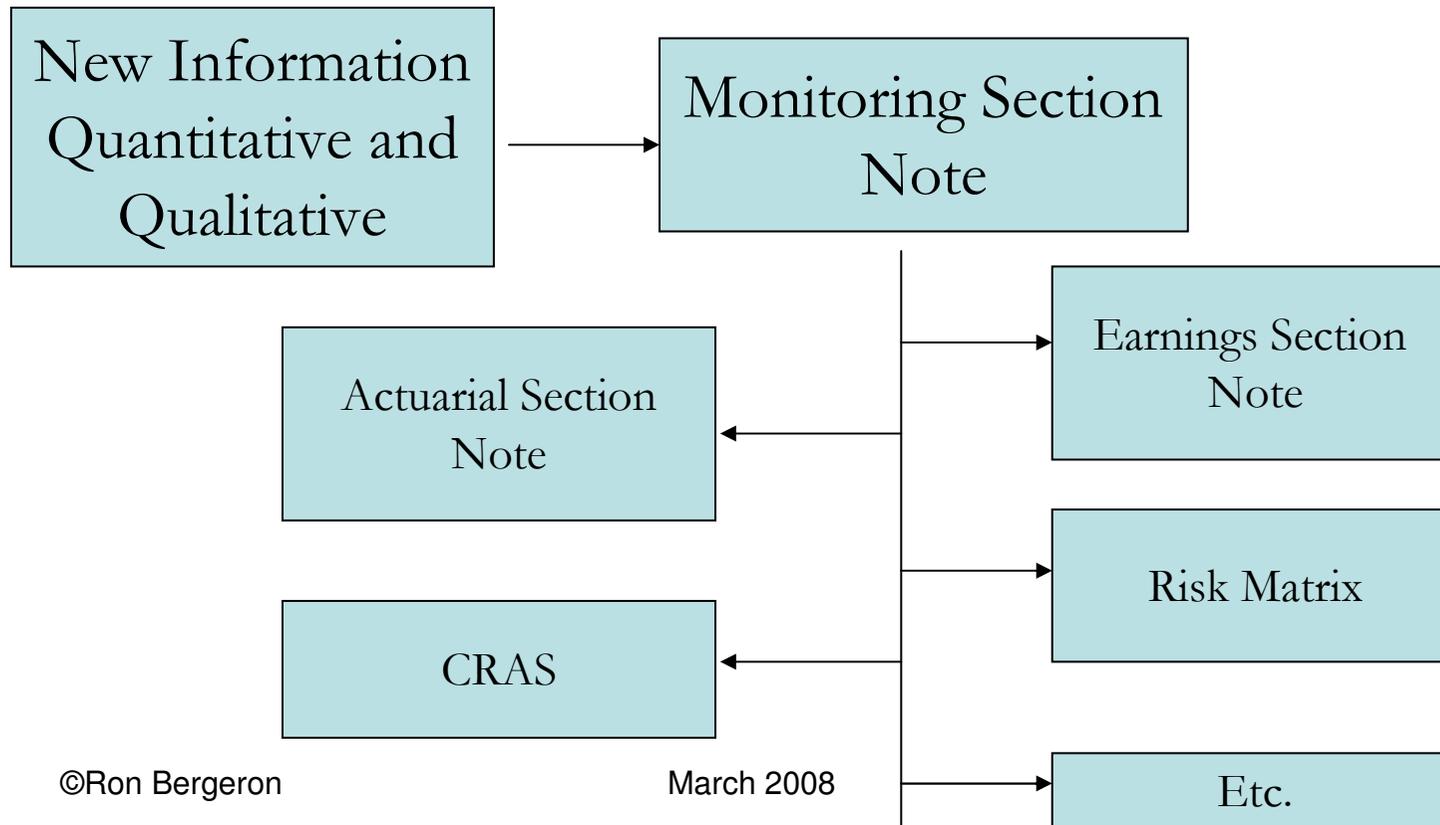
Key Principles:

- Exercise of Good Judgment as to which Areas Need to be Investigate Further
- Sufficient Knowledge of the External and Internal Environments
- Use of a Holistic Approach
- Dynamic and Continuous Process



Financial Analysis – Where do I Start?

Framework Documentation Flow





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What Do I Already Know About the Company?

- Review the Company Files for Latest Correspondence, Analysis, Etc.
- Check Company Website for New Information
- Review External Sources of Information e.g. Economic Reports, Rating Agency Reports, Industry Reports, etc.
- Other Types of Reports e.g. Reports Sent to Capital Market Authorities (Public Companies)



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Financial Analysis – Where do I Start?

- Has the Company Filed its Quarterly and Annual Financial Reports on Time?
- Early Warning Indicator Results and the Need to Get Familiar with Them
 - Understand the Guide
 - Compare Company Results Against Suggested Benchmarks, Peer Companies Results, and Industry Averages
 - Always Investigate the High and Low Results
 - Understand Circumstances that May Justify Results



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Financial Analysis – Investments

Characteristics to Look For in Any Asset Category:

- Liquidity (ability to convert investments into cash)
- Diversification / Mix (concentration risk)
- Quality (credit or default risk)
- Valuation (important for non-liquid and non-traded instruments)



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Investment - Quality and Diversification of Assets

- Do we Have a Copy of the Most Recent Investment Plan?
 - Is the Company Following its Plan?
 - Does the Strategy Make Sense Given the Context of the Product Lines?
- Is the Portfolio in Compliance with the Law?



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Investment - Quality and Diversification of Assets

- Adequacy of Diversification to:
 - Connected Groups
 - Major Industries
 - Geographic
 - Single Name Exposure i.e. a Company or Group
- Managing these Risks
- Shift in the Investment Portfolio
- Short Term Versus Long Term Mix



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Investment - Quality and Diversification of Assets

- Foreign Denominated Investments
- Exposure to Foreign Exchange Risk - Does it Make Sense Given the Liability Profile?
- Non-Investment Grade Instruments
- Disagreement on Provisions or Income Recognition with External Auditors



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Investment - Quality and Diversification of Assets

- Concerns with the Level of Investment in Real Estate
- Changes in Carrying Value of Real Estate
- What Type of Product Line is the Real Estate Matched Against?
- Nature of Receivables (Reinsurers, Agents, Brokers, etc.)



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Investment - Quality and Diversification of Assets

- Size of Receivables and How the Company Manages that Credit Risk
- Any Significant Shift in Receivables - How Does it Compare to Peers?
- Collectability of these Receivables – Policy and Practices
- Other Asset Categories
- Third Party Administrator (Outsourcing) and the Possibility of Contagion Risk



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Investment - Quality and Diversification of Assets

- Investments Sold at the End of the Period/Year (re. performance and matching risks)
- Purchase and Sale Agreements
- Accounting for Gains and Losses on the Sale of Investments
- Capitalization of Expenses
- Pledging of Assets (e.g. granting a security interest or lending a portion of a security portfolio)



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Investment - Liquidity

Why Should I Be Concerned About Liquidity?

- Negative Cash-flows Make the Management of Investment More Challenging – Where will the Cash Come from?
- At Mercy of Market Condition Volatility
- Reduce the Ability to Generate Reasonable Returns



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Investment - Liquidity

What Should I Be Looking For?

- Understand the Company Matching Strategy
- Company's Ability to Execute its Strategy
- Is the Mix of Product Liabilities an Issue i.e. Short Tail vs. Long Tail – Which Segment is Growing?
- How Does it Compare to Peers?
- Quality and Maturity Distribution of Investment Portfolio



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Reinsurance

Why Should I be Concerned about a Company's Reinsurance Program?

- Reinsurance is Designed to Reduce Risks not the Opposite
- Should be Designed to Spread Risks, Increase Capacity and Provide Stability in Earnings



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Reinsurance

A Reinsurance Program should Be Adequate Relative to:

- Policy Limits
- Underwriting Risks
- Catastrophe Exposures
- Business and Financial Capacity
- Credit Worthiness of Reinsurer



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Reinsurance

Are There Any Downside Risks to Reinsurance Activities?

- Yes, if the Direct Writer Becomes Dependent upon the Performance of the Reinsurer
- Yes, if the Direct Writer Becomes Exposed to the State of the Reinsurance Market in General



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Reinsurance

What Should I be Looking for?

- Formal Evaluation Process
- Has Anything Unusual Emerged Through Financial Reporting? How Significant?
- Reinsurance Arrangements Within the Same Group of Companies (Pooling of Risks)
- Irregularities in the Accounting



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Reinsurance

What Should I be Looking for?

- Retention Level
- Has the Retention Level Changed over the Last Period?
- Fronting – How Significant? Is the Book of Business Growing?
Is it Profitable?
 - Nature of the Arrangement
 - Kind of Risks
 - Level of Control the Direct Writer has on the Business Being Fronted



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Reinsurance

What Should I be Looking for?

- Disputed Accounts in Recoverable from Reinsurers
- Policy and Practice re. Doubtful Accounts
- Change in Reinsurance Program over the Last Period
- Change in Credit Worthiness and/or Solvency of Reinsurer



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Claims and Loss Adjustment Expenses (LAE) Reserves

Issues:

- Difficult to Estimate due to Lack of Industry Data, Hence Highly Subjective
- By Far the Largest Components of the Liabilities of P&C (Net of Reinsurance)
- Claims Include both Reported and Unreported
- Is Discounting of Certain Types of Claims Happening?
- Concerns – Are the Reserves Sufficient to Cover the Future Costs of Settling all Claims?



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Claims and Loss Adjustment Expenses (LAE) Reserves

What Should I be Looking for?

- Use of Anticipated Salvage and Subrogation Values to Reduce Claims and LAE Reserves
- How significant is the Practice
- Where Does the Company Gets its Data?
- How Reliable is the Data?
- Has the Company Ever Abused this Practice?



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Claims and Loss Adjustment Expenses (LAE) Reserves

What Should I be Looking for?

- Change in Unpaid and LAE Reserves > 50% - Consider Reviewing Five-Year Historical Data to Identify Adverse Trend or Fluctuation
- What Were the Reasons?
- May be an Indication of the Need to Strengthen IBNR and LAE Reserves
- Change in Business Practices



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Unearned Premium Reserves

What Should I be Looking for?

- Reserves Should Move in Tandem with Change in Premiums
- Check How the Unearned Premium Reserves are Calculated
- Test Accuracy of Data



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Capital and Shareholders' Equity (Surplus)

What Should I be Looking for?

- Is the Level in Compliance with the Law?
- As there Been a Change in Ownership?
- As there Been a Shift in Capital Over the Last Period?
- Was What the Rationale for the Change? Is this According to Plans?
- Is this a One Time Adjustment or Do you Expect this Trend to Continue?



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Capital and Shareholders' Equity

What Should I be Looking for?

- Adequate to Support Current and Future Activities?
- Is the Parent Willing and Capable of Injecting New Capital as Needed?
How Do you Know that for Sure?
- Has there Been a Transfer of Business Over the Last Period (Purchase or Sale)? How Large?
- If so, How Was it Accounted for?
- Have Dividends Been Paid Over the Last Period?
- Is the Company in a Weaker Solvency Position as a Result?



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Earnings

Why Are Earnings Important?

- Support Current Operations
- Absorb Normal and Expected losses
- Increase Capital when Retained
- Reflect Management's Ability to Achieve Objectives
- Enhance Institution's Ability to Raise Capital



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Earnings

Earnings Characteristics:

- **Size** – According to Plans? Compare to Peers?
- **Quality** – Sustainability? Non-Recurring Items? Change in Accounting or Actuarial Practices?
- **Volatility** – Is this a Reflection of Higher Risk activities? Due to Income Management?
- **Composition** – Susceptibility Due to Change in Environment? Cash vs. Non-Cash Sources?



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Earnings

What Should I be Looking for?

- Assess Earnings Composition by Major Lines of Business
- How Volatile Has Earnings Been Over the Last Five Quarters?
- If Volatile, What Seems to be the Main Reasons?
- Has there Been a Change in Actuarial and/or Accounting Practices?



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Earnings

What Should I be Looking for?

- Is the Change in Premiums Over the Last Quarter, Year Within a Reasonable Range i.e. -10% to +30%
- Has the Company Entered into New Lines of Business?
- Is this According to Plans?
- Does it Have the Expertise to Write these New Lines?
- Is the Growth in Underwriting Expenses in Line with the Growth in Premiums? Compare to Peer Results



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Earnings

What Should I be Looking for?

- Is the Allocation of Expenses Across Lines of Business Reasonable? Compare to Peer Results.
- Review Trends in the Following Ratios Over the Last Three Years:
 - Combined Ratio
 - Loss Ratio by Lines of Business
 - Expense and Commission Ratios by Lines of Business
 - Investment Yield



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Earnings

What Should I be Looking for?

- How Significant are the Fees Paid to Related Companies that Provide Outsourcing Services to the Company?
- What Activities Are Being Outsourced?
- How Does it Compare to Peers?
- Are Any of the Outsourcing Companies Owned Directly or Indirectly by Senior Management?
- How Significant Are the Fees Paid to these Companies?
- Are the Fees Set at Market for the Services Provided?



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QUESTIONS?