

Rating Methodology by Sector

Non-life Insurance

This rating methodology mainly applies to non-life insurance companies and non-life insurance groups in Japan. It also applies to mutual aid corporations that handle non-life mutual aid. For overseas non-life insurance companies and others, JCR applies this rating methodology after making necessary adjustments to the analytical indicators based on the laws, accounting systems, regulations, and financial administration, etc. in the country or region where those companies are located. Similarly, for specialized reinsurance companies, JCR applies this rating methodology, paying attention to the characteristics of business, location of risks, and nature of the system.

1. Business Foundation

(1) Industry Characteristics

(i) Market size and growth potential

The non-life insurance business handles insurance products for losses caused by certain accidental events (so-called second-sector) and bodily injury and illness (so-called third-sector) in accordance with the Insurance Business Act.

The non-life insurance market is large and expanding moderately. Non-life insurance is an indispensable function for the stability of people's lives and the sound development of the economy, and as society's risks become more diversified, new needs arise there. Japan's population is on a declining trend, and demographic changes due to the falling birthrate and aging population are expected to further develop. Although it is difficult to expect high growth in the non-life insurance market due to the limited expansion of needs for traditional non-life insurance such as automobile insurance, JCR believes that the market is unlikely to shrink rapidly.

With regard to automobile insurance, which is the main product of many non-life insurers, the impact of the penetration of CASE (connected, automated driving, sharing, and electrification) and MaaS (Mobility as a Service) is expected, among others. Although JCR does not expect the automobile insurance market to change significantly in the short run, it is necessary to monitor the spread of automated vehicles, environmental improvements, and legislative measures from a medium- to long-term perspective.

(ii) Competition

The non-life insurance business is licensed, and there are relatively high barriers to entry. As for sales channels, exclusive agents continue to have a large presence, but they are diversifying, such as joint agencies (insurance shops), bancassurance, and direct (Internet) channels. Non-life insurers have little room for differentiation in their products, so it is not easy for them to secure a competitive advantage. Although there is a certain amount of competition in all sales channels, the market is dominated by major non-life insurers, and the growing

awareness of risk and return due to the prevalence of ERM (Enterprise Risk Management) is making excessive price competition less likely.

(iii) Transaction stability

Non-life insurance products include automobile, fire, marine, and personal accident insurance, as well as liability insurance, expense/ profit insurance, workers' compensation and employers' liability insurance, and pet insurance (so-called new types of insurance). Non-life insurance products are not patent subjects, and even if a company develops products that captures customer needs, it is likely to be followed by competitors. Contract terms are relatively short, and contracts are basically renewed each time the maturity date arrives. Currently, there is no significant difference in product quality, and since agents, who account for the majority of sales channels, have a strong grip on customers, cancellations and switching are unlikely to occur, and the policy persistency rate is stable at a high level.

(iv) Protection and regulation

Non-life insurance companies are supervised by Financial Services Agency and are required to calculate a solvency margin ratio, which assesses financial soundness by measuring the amount of risks (required capital) based on economic value assessments of assets and liabilities and evaluating the ratio of capital (eligible capital) against it. Partly because the ratio is calculated based on economic value, it is referred to as ESR (Economic Value-based Solvency Ratio). If ESR falls below 100%, early corrective measures are triggered in stages according to the degree of the shortfall.

In addition, non-life insurance companies are subject to bankruptcy resolution procedures under the Insurance Business Act and the Act on Special Measures for the Reorganization Proceedings of Financial Institutions. Non-life Insurance Policy-holders Protection Corporation of Japan has been established to protect policyholders of bankrupt non-life insurance companies by providing financial assistance for the transfer of insurance policies of bankrupt insurance companies and the payment of covered insurance claims.

On the other hand, financial system incorporates various measures (prudential policies) to maintain stability and efficiently function. The expected protection for insurance companies and insurance holding companies is weak compared to that of banks.

(2) Market Position and Competitiveness

The market position and competitiveness of non-life insurance companies are important for ensuring stable earnings over the medium to long term. The depth and characteristics of the customer base, diversity of sales channels and sales capabilities, uniqueness of product and management strategies, brand power, and high customer convenience through the use of digital and other means determine market position and competitiveness.

Regarding the customer base, JCR evaluates the number of customers (policyholders), characteristics of the customer segment, and the size and stability of net premiums written. Some non-life insurers, for example,

belonging to certain corporate groups, have defended themselves against competitors' offensives in their customer bases with their unique channel and product strategies, and have a high presence over a long period of time. JCR also incorporates into its evaluation the possibility that such non-life insurers will demonstrate earnings power for the future.

JCR evaluates how well the new customers are being acquired by the sales channel's sales force and product appeal. For the sales channel, JCR confirms whether the company is accurately capturing diversifying customer needs. In particular, it is important whether the company has established an appropriate relationship with agency channel. In terms of product strategy, in addition to the fullness of product lineup, key point is whether the company is able to quickly and flexibly respond to changes in customer needs. It is not easy to differentiate its products from those of other companies, and merchantability (ease of understanding), marketing ingenuity, and skillful promotion are related to the differentiation.

(3) Management Strategy and Governance

Management strategy and governance are factors that affect the direction of business foundation, and also financial foundation. With regard to management strategy, JCR evaluates whether the company is able to formulate and execute a management strategy that takes into account changes in the business environment. JCR also focuses on the direction of risk appetite and the extent to which the ERM culture has penetrated within the company. With regard to governance, JCR checks whether a check-and-balance function adequately is functioning through the corporate governance system, such as the board of directors, management control system, risk management and internal control such as compliance, while taking into account the size of the organization. In the event of misconduct, risk of damage to the business foundation due to loss of reputation will become apparent. Therefore, JCR checks whether a system is in place to prevent misconduct from occurring, and whether a system will be in place to prevent similar incidents from recurring in the future when such misconduct has occurred.

2. Financial Foundation

(1) Earnings Power

In evaluating earnings power, in addition to the scale of earnings and stability of profits from the core insurance business, JCR also analyzes the earnings power of the asset management. While future performance will be factored into the evaluation, JCR takes into account the possibility that changes in the business environment and management strategy can bring changes to the earnings structure of non-life insurance companies, in addition to past performance trends. JCR also takes into account risk-return balance, as non-life insurers have different risk profiles.

In analyzing earnings power, JCR focuses on the level of the combined ratio. Since profit of non-life insurance companies is subject to fluctuation due to the occurrence of major natural disasters such as windstorms, floods, and earthquakes, as well as major accidents, JCR confirms a profit level with one-time effects leveled off by taking it as a moving average over a certain period. It is extremely important for non-life

insurers to build a well-diversified business portfolio in terms of risk type and geographic location to ensure profit stability, and JCR pays attention to the status of such efforts. JCR also confirms the extent to which the volatility of periodic profit/loss is controlled based on the company's policies for the establishment of reinsurance schemes and the accumulation of catastrophe loss reserve.

It is also important to confirm that the company has set appropriate premium rates commensurate with risk. For automobile and fire insurance, which are the main products in the retail sector, profitability could deteriorate if premiums are not set in line with the actual loss ratios, referring to the advisory pure premium rates calculated by General Insurance Rating Organization of Japan. For corporate non-life insurance, which is more individualized, it is important to check whether the company sets premiums in accordance with its own loss ratio and risk status, and also can control revenue and expenses appropriately by, for example, limiting underwriting of excessive risks. In the field of new types of insurance, products must be designed based on appropriate risk management, such as ensuring profitability, because they cover specific risks that are not covered by traditional non-life insurance. For insurance types with deteriorating profitability, JCR checks the adequacy and progress of measures to improve profitability, such as policies for premium rate revision and product revision, and restrictions on or stricter underwriting.

With regard to asset management, JCR mainly analyzes income gains from interest-bearing bonds, which are expected to contribute to securing stable earnings over the medium to long term. JCR takes into account that capital gains/losses are in many cases easily influenced by market conditions. JCR checks medium-term trends, such as whether the balance of investment assets has been built up to generate stable income that is less susceptible to temporary increases or decreases due to aggressive risk-taking.

Key financial indicators

- Combined ratio
- Net premiums written
- Underwriting profit (loss)
- Investment income (loss)

(2) Asset Quality (Asset Management)

Although the asset allocation, risk and return of each asset varies among non-life insurers, JCR analyzes whether they secure returns commensurate with risk while controlling price fluctuation risk and interest rate risk by managing assets in a way that matches the characteristics of the liabilities. JCR also makes an analysis of ALM and risk management techniques, composition of investment assets, and derivatives transactions. Since the risk-return approach to asset management differs depending on the asset management policy of each company, it should be noted that the composition of securities, real estate, loans, and other assets, which account for the majority of assets held, differs. Based on the composition of investment assets, JCR checks whether the risk of each individual asset is not excessively large relative to capital and others and the diversification effect of the assets as a whole. Based on the recognition of the basic risk-taking policy, JCR evaluates the appropriateness of the investment stance, adequacy of personnel and systems for asset

management, and status of securing returns.

Key financial indicator

- Composition ratio of asset portfolio

(3) Capital Adequacy

Regarding the financial foundation, JCR places the greatest emphasis on capital adequacy from a quantitative perspective, evaluating capital adequacy in terms of economic value, which is a market value assessment of assets and liabilities as a whole.

As an indicator, JCR pays particular attention to ESR. Since ESR is a numerical value based on internal management-based risk management and differs in terms of assumptions, JCR evaluates ESR by paying attention to trends in regulations and changes in calculation standards both in and outside Japan. While internal management-based ESR, which represents the characteristics of each company, is the main target of the assessment, JCR also incorporates regulatory-based ESR whose prerequisites are standardized to a certain extent for comparability. As regards funding instruments that meet regulatory capital requirements, including hybrid securities that have the characteristics of both equity and liabilities, JCR basically incorporates them into the assessment by taking into account their equity content equivalent to regulations.

The effective components of capital for confirming capital adequacy ratio based on financial accounting include capital stock and capital surplus, as well as various reserves such as price fluctuation reserve and catastrophe loss reserve.

In general, non-life insurance companies have shorter asset and liability durations and smaller duration gaps than life insurance companies. Therefore, ESR of non-life insurance companies is less sensitive to interest rates than that of life insurance companies and remains stable. While considering ESR as a quantitative indicator, JCR pays attention to whether risk buffers are sufficiently secured through risk-based capital management, such as sales of cross-shareholding shares and underwriting risk through the use of reinsurance.

Key financial indicators

- Solvency margin ratio (ESR)
- Capital adequacy ratio

(4) Liquidity

Regarding liquidity, JCR confirms that the company possesses highly liquid assets that enable it to respond quickly in times of stress, such as an occurrence of a major natural disaster. JCR confirms that liquidity risk management is in place to enable reliable payment even if market risk or credit risk materializes during a financial crisis. A sharp increase in cash surrender values for savings-type products could be assumed in cases of dynamic cancellations, where cancellations increase due to switching to more advantageous products when the market fluctuates, or in cases where the reputation of the non-life insurance company is severely damaged due to a deterioration in the business conditions.

Key financial indicator

- Liquid assets (cash, deposits, government bonds, etc.)

(5) Risk Management System

JCR focuses on the integrated management system of earnings and capital based on risk management, and checks the status of ERM development and progress in upgrading it. While excellent risk management is unlikely to be a positive factor in the evaluation, it can be a negative factor if it is considered that there is room for improvement in risk management. JCR mainly evaluates whether the company has incorporated an economic value-based approach into its management strategy and has secured an appropriate balance between risk and return. JCR also confirms whether the company comprehensively and accurately assesses various types of risks, identifies risks that have a significant impact on management, and can appropriately allocate capital accordingly. For effective risk management, it is necessary to elaborate and upgrade the risk management system.

In the non-life insurance business, since the impact of large-scale natural disasters and major accidents is inevitable, it is extremely important for non-life insurers to build a well-diversified business portfolio in terms of risk type and geographic location. In addition, JCR also confirms whether major non-life insurers have a global and group-wide ERM system in place, given the trend toward an increase in the number of group companies in Japan and overseas. The “Own Risk and Solvency Assessment (‘ORSA’) reports” are a useful tool for understanding the status of ERM and risk management systems.

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Japan Credit Rating Agency, Ltd.

Jiji Press Building, 5-15-8 Ginza,
Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026
