GCR GLOBAL CREDIT RATING CO.
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Rating Methodology

Insurance

Criteria for Rating South African Medical Schemes

Updated May 2018

Introduction

Incorporating both quantitative and qualitative factors, GCR's ratings reflect an evaluation of the organisation's current financial position, as well as how that may change in the medium term. In its quantitative analysis, GCR focuses on fundamentals, analysing an institution's historical and current financial performance. This is used as a foundation for developing expectations regarding the institution's future financial performance and risk profile, under both normal and stressed operating scenarios. Emphasis is also placed on assessing the operating environment (including both economic and industry risk), strategy, market position, diversification, as well as corporate governance, strategic and risk management, all of which also form part of the qualitative analysis.

GCR's claims paying ability ("CPA") ratings give an opinion of an entity's relative ability to honour policyholder and related contract obligations.

This criteria report ("the Criteria") is an update to the version published in July 2017. There are no significant amendments to the Criteria. The update of this Criteria will not have an impact on any existing ratings. Going forward, this Criteria will be applied to all ratings of South African Medical Schemes.

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Rating methodology

GCR's ratings give an opinion of a medical scheme's relative ability to honour policyholder and related contract obligations. The ratings reflect an opinion on the relative financial position of the medical scheme. Ratings are forward looking and represent a view on the medical scheme's creditworthiness over a two year time horizon. Accordingly, key rating factors are considered with a focus on how the relevant measures are expected to evolve over time. The ratings do not directly consider the medical scheme's quality of service levels or the appropriateness of its product offering, unless these factors directly impact on the medical scheme's longer term sustainability.

GCR's analysis and conclusions place emphasis on different factors for each medical scheme, depending on its unique characteristics and risk profile. The following discussion provides an overview of the qualitative and quantitative factors that GCR considers when analysing the credit quality of a medical scheme.

Operating environment

GCR undertakes a qualitative assessment of the risks related to the industry, regulatory conditions, and future systemic or external risks that could develop as various conditions change.
The following aspects are assessed:

- Membership growth trends.
- Industry performance and related market conditions, such as medical cost inflation, utilisation patterns, and related items.
- Degree of control over pricing and associated premium income levels.
- Regulatory environment and mandates.

In certain instances, particular risks or structures (at either industry or country level) may result in GCR applying an industry rating ceiling, which caps the rating that a participant in a particular market can achieve. An industry rating ceiling may be imposed by GCR should the fundamentals and characteristics of the market represent an inherent limitation on the credit rating profile assessed at a rated-entity level. Such rating limitations can include (but are not limited to) systemic risks that impact on all participants, market maturity, limitations in terms of organisational structure & associated capital flexibility, or regulatory frameworks that impact negatively on key criteria and decisions relative to credit rating criteria.

Membership and products

The size of the membership base may contribute positively to credit strength in the medical schemes industry. The benefits of size include membership base diversification and cross-subsidisation, economies of scale and potential for improved negotiating leverage with service providers. This notwithstanding, the ability to attract specific target groupings that allow for a favourable risk profile and consequent strong performance forms a material analytical component.
Key considerations include:

- The medical scheme's growth strategy in the short and long-term, competitive advantages and defensive characteristics.
- Marketing, sales and retention initiatives.
- Alignment of distribution channels with target market.
- Concentration of risk in terms of distribution channels and buyer groups.
- Affiliated relationships.
- Actual and/or potential mergers and/or amalgamations.
- The membership base's risk composition, including average age, pensioner ratio, claiming profile and related factors.
- Member distribution by product. Breadth of product and service offerings and potential differentiation benefits.
- Wellness initiatives.

Financial performance

Medical schemes that are able to demonstrate a consistent positive financial performance year-on-year and a lower degree of volatility generally receive higher ratings. A track record of underwriting and net surpluses through claims cycles attests to the relative success of the medical scheme's business model and management's ability to adapt to changing market conditions appropriately. In this regard, a medical scheme's financial performance will ultimately drive future balance sheet strength and sustainability. GCR considers several measures of financial performance and calculates these through the review cycle, with reference to industry averages and trends.
The following factors are considered:

- Pricing approach, contribution rate changes and gross premium growth drivers.
- Claiming patterns and the adequacy of systems to monitor these.
- Provider relationships i.e. managed care service provision, service provider networks, designated service providers, service level agreements and other related services.
- Non-healthcare expense management and control (with attention being placed on assessing the medical scheme's ability to effectively negotiate and rationalise all non-healthcare costs).

- Key financial ratio trends in comparison with peer and industry group averages.
- Economies of scale, expense efficiencies and related pricing advantages.
- Performance of product types and compliance with regulatory requirements.
- In exceptional circumstances, where reinsurance arrangements have been authorised by the regulatory body, the structure is analysed, together with the diversification and credit quality of the underlying reinsurers.

Balance sheet strength

A medical scheme's balance sheet strength and composition, and its ability to preserve and grow its assets and members' reserves are key factors in assigning the rating.

Member reserve strength
Notwithstanding the non-profit status of medical schemes, entities aim to accumulate reserves (within reason) in order to ensure their sustainability, given fluctuating claiming patterns and cost pressures, exposure to market and counterparty risk, and a dynamic regulatory environment. Reserves are accumulated when the scheme achieves a net surplus for the year. This is dependent on two factors, namely the medical scheme's net healthcare performance and its investment performance. Furthermore, by maintaining reserves in excess of the level necessary for their short-term operating requirements, they build a buffer against adverse claiming years and in certain circumstances, are able to limit contribution increases to a degree. In rare cases, access to external sources of funding may be a rating consideration.

A medical scheme's level of capitalisation is evaluated using the international solvency ratio, which provides an indication of its reserves (measured as accumulated funds combined with revaluation reserves), relative to its risk premiums. It therefore takes into account the longer-term component of balance sheet strength, as well as the medical scheme's nearer term risk exposure, reflecting the degree to which it is able to withstand variability in the operating environment over time. GCR also considers reserve strength per principal member, together with the number of months' worth of claims covered by the scheme's accumulated reserves.

Regulatory risk
The medical scheme's compliance with regulatory solvency requirements is also given due consideration, as this can impact on its sustainability as a going concern.

In the event that a medical scheme encounters solvency strain, GCR will examine the underlying reasons for the discrepancy, and gain a thorough understanding of the business plan aimed at rectifying the position going forward.

Asset management and liquidity
The quality and composition of the investment portfolio has a direct impact on a medical scheme's overall net performance and member reserve levels, and is a key consideration in GCR's analysis of balance sheet strength. It is noted that medical schemes are restricted by regulations in terms of their asset allocation, which GCR analyses together with compliance. The credit quality of counterparties is also considered, and solvency may in certain circumstances be adjusted to account for undue credit risk. Medical schemes are generally expected to maintain relatively conservative investment portfolios, given a lower tolerance for market fluctuations in line with their operational mandates. Liquidity distinguishes between cash and liquid investments, which may be immediately realised to pay claims, and funds tied up in other investments. GCR analyses trends in a medical scheme's cash flow management and cash coverage ratios, which measure the number of months' claims that can be paid from existing cash holdings. Once an adequate liquidity level is reached, medical schemes may look to realign their investment portfolios (remaining in compliance with regulations) to generate higher returns (albeit typically at higher risk), and thus strengthen reserves.

Risk management and strategic management

Medical schemes that develop formal risk management frameworks to identify and manage risks within accepted risk tolerance levels (and continuously analyse the effectiveness thereof) are better equipped to respond to emerging risks in a flexible manner and consequently lessen financial volatility. This requires an entrenched risk management culture that extends to all aspects of the business. Furthermore, medical schemes operate in dynamic environments and need to identify and address potential risks on an ongoing basis. The establishment of internal risk management frameworks enables medical schemes to stay abreast with corporate governance, risk management and legal compliance mandates. Accordingly, the emphasis that a medical scheme places on risk management (both proactively and reactively) is an important consideration in the rating decision.
The following factors are considered:

- The risk management culture in the organisation and the efficient communication thereof. Moreover, the extent to which this has been embedded in the business operations is assessed.
- The breadth and depth of a formal risk management framework. Further, an assessment of the continuous self-analysis of the risk management strategies and policies is undertaken in order to evaluate their effectiveness.
- The company's access to and level of sophistication of scientific risk measurement tools.

Operational success, and consequently the financial strength and credit worthiness of an entity, depends on the quality and effectiveness of its management. GCR evaluates management's strategy in relation to the company's overall strengths and the current market environment.
The following factors are considered:

- Strategic goals and planning.
- Strategic implementation track record.
- Appetite for risk.
- Controls and the degree to which risk management evolves over time.

Corporate governance

Board effectiveness and composition
The governance structure of a medical scheme begins with the Board of Trustees ("BoT"), its composition, and the adequacy of reporting lines. A medical scheme should have a BoT that governs, directs and is in effective control of the company on behalf of the scheme members. The BoT should act as the focal point for corporate governance, provide effective leadership and oversight based on sound ethical foundations.

Competent, independent and high-performing BoTs are important to set a scheme's strategic direction, challenge executive management's strategy and decisions constructively, and ensure that the entity is run and led effectively in a sustainable way. Effective BoTs must include non-executive and independent members with diverse skills, competencies, views and professional experience. The oversight role of the BoT plays an integral part in how management performance is measured, rewarded and disciplined.

Support committees
The BoT should be assisted by specialised committees with well-defined terms of reference, including strategy, remuneration, audit and nomination committees. Furthermore, the annual audit must be conducted by reputable external auditors selected by an independent audit committee that have oversight over quality of financial reporting.

Independence & Conflicts of interest
A BoT with apparent conflict of interest, or one that is not committed to fulfilling its oversight responsibilities, can contribute to a weakening in management disciplines and behaviour. Potential conflict of interest for a rated entity is assessed in terms of related-party transactions.

Appendix A: Explanation of National Scale and International Scale Ratings

GCR's local currency National Scale ratings are designed to enable appropriate differentiation of credit quality within a specific country. Particularly in developing countries, where the sovereign ratings tend to be below investment grade, utilising the International Scale has the consequence of compressing ratings within a limited number of rating bands, thus providing limited differentiation among credits.

In according National Scale ratings, sovereign risk factors are neutralised as it is assumed that all medical schemes within a given country or jurisdiction will be impacted equally. This allows for ratings to be tiered against an assumed lowest risk rating of 'AAA' within each country or jurisdiction. This lowest risk will normally, although not always, be assigned to the financial commitments issued or guaranteed by the sovereign state. Certain markets may, however, be characterised by inherent limitations that impose a ceiling on the ratings that can be accorded to entities that operate in these markets. National Scale medical scheme ratings are intended to be comparable only in a single country or jurisdiction (denoted by a special modifier).

On the other hand, GCR's International Scale ratings are tiered against a global pool of healthcare and insurance entities. Thus, the highest rating that can be achieved will be limited by the credit quality of the country in which the medical scheme is domiciled (or conducts the majority of its business). Exceptions can arise where the medical scheme's rating may pierce the sovereign rating; for example where the entity has significant assets domiciled or revenue sourced offshore, or there are guarantees from foreign entities in place.

Rating medical schemes on an International Scale introduces additional factors related to sovereign risk, including political risks, the robustness of the legal system and transfer and convertibility risk. While such risks are generally considered when according all medical scheme ratings, this is done on a more micro level with regard to the specific factors affecting the company or industry under review. For International Scale ratings, a greater macro approach is followed, and the risk factors of the sovereign as a whole are measured against other sovereigns or business jurisdictions.

Political risks are more acute in countries where the democracy is young or even limited. Nevertheless, the principles of good governance and the ability of the government to deliver on development goals are constant across all jurisdictions. Closely related to political risk is societal stability. To the extent there is social instability, the business environment is likely to be negatively impacted, and accordingly the rating of entities in the jurisdiction constrained. To the extent that such factors improve, due to solid economic growth or the successful delivery of development plans, ratings would be positively impacted.

Political stability also adds greatly to the strength of the legal system. History has also shown that changes in government can have a destabilising impact on policies and regulations. Well defined and defensible property rights are critical for a strong business environment; while the absence of such rights or weak enforceability would significantly constrain the International Scale ratings of all entities in the country due to the much higher risk. Even where a sound legal system is in place, GCR is cognisant of the fact that in many developing countries, historical case law regarding financial transactions may be lacking. This would introduce increased uncertainty into the enforceability of rights detailed in more complex financial products.

Transfer and convertibility risk relates to the ability of medical schemes in a country to convert earnings between local and foreign currencies and to transfer funds abroad in the normal course of business. Countries where such risks are high tend to be those where currency controls are in place and approval from the relevant authorities is necessary for cross border transactions to occur. Challenges may also occur in small economies, were the currency market does not have sufficient scale to timeously convert large amounts of currency at the prevailing conversion rate. Transfer and convertibility are of greater concern where a corporate generates the majority of its revenue in the local currency but has foreign currency denominated debt. If sufficient funds cannot be converted and transferred cross-border, a default on obligations may occur, even when the entity has sufficient financial resources.

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GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S INSURANCE GLOSSARY

Accumulated funds	An amount representing the accumulation of historical and current net surpluses and deficits, held for the benefit of members and their dependants.
Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Balance Sheet	Also known as a Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Benefits	Financial reimbursement and other services provided covered by medical schemes under the terms of a medical scheme plan.
Bond	A long term debt instrument issued by either: a company, institution or the government to raise funds.
Claim	A request for payment of a loss, which may come under the terms of a medical scheme plan.
Commission	A certain percentage of premiums produced that is received or paid out as compensation by a medical scheme to agents and brokers.
Coverage	The scope of the protection provided under a contract of a medical scheme plan.
Interest	Money paid for the use of money.
Liquidity	The ability of a medical scheme to convert its assets into cash to pay claims if necessary.
Loss	The happening of the event for which a medical scheme pays.
Market Value	The price for which something would sell, especially the value of certain types of assets, such as stocks and bonds. It is based on what they would sell for under current market conditions.
Members' surplus	Accumulated funds plus revaluation reserves.
Portfolio	The total securities owned by a medical scheme.
Provision	A technical reserve of a medical scheme established to provide for the future liability for claims which have occurred but which have not yet been settled.
Risk	(1) Uncertainty as to the outcome of an event when two or more possibilities exist. (2) A person or thing covered by a medical scheme.
Securities	Evidences of a debt or of ownership, as stocks, bonds, and checks.
Solvency	Reserves (accumulated funds or members' surplus) expressed as a percentage of contributions (gross or net).
Statutory	Required by or having to do with law or statute.
Term	The period of time for which a policy or bond is issued.
Valuation	Estimation of the value of an item, usually by appraisal.