

Guardrisk Insurance Company Limited

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South African Insurance Analysis

Security Class	Currency	Rating	Date	Rating Watch	Previous Rating
Claims paying ability	Rand	AA	12/2003	No	AA

Rating Rationale

Our rating is based on the following key factors:

- The “first-to-market” benefits enjoyed by Guardrisk Insurance Company Limited (“Guardrisk”) in the cell captive market.
- Guardrisk’s comparative advantage in sourcing and writing cell captive business, given its parent company, although diversifying distribution channels is becoming increasingly more important.
- The cell captive will experience increasing difficulty in purchasing large reinsurance capacity in the local market.
- Pending accounting regulations, which may impact the way in which Guardrisk (and the industry) conduct business.

Capital Structure

Each Guardrisk cell is capitalised in order to provide adequate capacity to underwrite risk. Of a total of 65 cells, representing 74% of premium income, 7 cells were undercapitalised (utilising the promoters capital), whilst 21 cells reported very high solvency margins. Overall the solvency margin was 44% in F03, which was in line with that reported last year. Although the financial base ratio declined for the third consecutive year, to 162%, it remains conservative, suggesting adequate reserving. Management advises that the solvency margin for the promoter’s cell (including contingency risk business) remains above the overall statutory solvency requirement.

Potential Risks

Given increased reinsurance rates worldwide and the recent consolidation within the South African insurance industry, reinsurance capacity in the insurance industry is shrinking. Unlike other captive domiciles, there is no legislation governing the cell captive industry in South Africa, providing for the legal segregation and protection of the assets and liabilities of each separate participating cell against the promoter cell (commonly known as Protected Cell Companies, or PCCs). In South Africa contractual cells are protected by the shareholder agreement and reinsurance contracts. In this regard, extensive reinsurance is purchased by Guardrisk.

Fundamentals

Guardrisk is registered as a short term insurer offering cell captive facilities. The ultimate holding company of Guardrisk is financial services group Alexander Forbes. In 2002, Alexander Forbes sold 30% of its South African business to Millennium Consolidated Investments (Proprietary) Limited, a black empowerment company.

Industry Overview

Guardrisk Insurance Company Limited ("Guardrisk") has been an industry leader in the promulgation of the cell captive concept, and has amassed a significant share of the market. Competing cell captive insurers include, SA Eagle Risk, Mutual & Federal Risk and Nova Risk Partners. Given the relative number of insured parties fitting the profile for cell captive insurance in South Africa and the low economic growth rate, the industry has moved from the self-funding concept to more profitable captive insurance underwriting (more scope). Whilst some cell captives (controlled by multiline insurers) have remained self-insured focused, others have mimicked the captive insurance market (using the third party concept - where risks displaying homogeneous characteristics, having a common distribution/branding thread, are effectively underwritten in a quasi-mutual arrangement, within a cell captive environment). This concept, as well as self-insurance on a smaller scale (through contingency policies), has also been offered by cell captives (via the promoter's cell), with more loosely structured arrangements facilitated by traditional insurers, such as Hollard and Santam (via their ART programmes). Whilst both SA Eagle Risk and M&F Risk remain appendages of their multi-line parents and relatively small players in the ART market, their presence remains a competitive threat, given their parentage and resultant access to the reinsurance market.

Cell captives continue to make inroads into the insurance market, as demand for cell captive insurance grows, commanding a combined share of around 9% in 2002, from 8% a year ago. It is noted that Guardrisk's share of the market has come under pressure since its monopoly in the late 90s. GCR is unable to determine the movement in market share in F03 (due to its competitors having June and December year ends), although Guardrisk's gross premium income ("GPI") increased from R1bn to R1.4bn in F03. Although Guardrisk remains the dominant cell captive insurer in South Africa, this is expected to come under pressure as new cell captive insurers enter the market. In this regard, Guardrisk continue to diversify their product offering.

Market Environment

The insurance industry reported GPI growth of 17% for 2002, which was the highest level of the past five years. This growth was largely attributed to rate increases (owing to consolidation, inflation and the increased cost of reinsurance), although some volume growth was observed. Furthermore, the rapid consolidation within the broker industry, as well as the reorganisation of broker alliances, provided further impetus to premium growth for some

underwriters. After turning positive in 2001, for the first time since 1997, the underwriting cycle in South Africa continued to improve in 2002, following years of intense competition, perverse pricing and sub-optimal investment returns. The degree to which the underwriting trend could continue to improve, however, depends on a number of external factors, including inflation expectations, GDP growth, Rand volatility and the cost of reinsurance. In addition, the possible cost implications relating to broker compliance (new policyholder protection rules), as well as the decapping of commissions, which will become effective on a date still to be decided by the registrar, after the Financial Advisory and Intermediary Services Act becomes effective, must also be taken into account.

The sharp depreciation of the Rand during 2001 saw PPI accelerate to 14.2% in 2002. Driven by the high producer inflation, consumer inflation increased significantly during 2002. CPIX rose from a low of 5.8% recorded in September 2001 to a high of 12.7% in November 2002. Subsequently, the index declined to an annualised rate of 8.3% by April 2003, fuelled by the higher interest rate environment. CPIX is expected to decline to within the South African Reserve Bank's ("SARB's") target range of 3% to 6% by the end of 2003. Although this will ease average claims settlement values going forward, low inflation levels will put pressure on those insurers wishing to pass significant premium increases. Furthermore, GDP growth began to taper off in 3Q 2002, to average 3% for 2002, mostly as a result of the slower growth in the agriculture, mining and manufacturing sectors (which were heavily impacted by the recovery of the Rand) and reductions in domestic consumer expenditure, due to the higher interest rates. Failing higher economic growth (together with lower inflation levels), the insurance sector will remain dependant on relative market share shift for business growth, which, given the recent consolidation, could prove difficult.

With regards to reinsurance, following the events of September 11th, the reinsurance market has experienced a reduction in capital, resulting in the immediate repricing of programmes. This has and will continue to filter into the insurance market. In addition, certain risks are no longer reinsurable, thus increasing the levels at which the insurance market would have to internally fund such risks, to either retain market share or satisfy consumer appetite. As a result of the recent consolidation within the South African insurance industry, it has been an opportune time for local reinsurers to price even higher rates into higher levels of reinsurance cover, leaving insurers to pass on the costs to their policyholders. Moreover, for those insurers that rely on selective reinsurance programmes, this pricing problem could

be more acute. In particular, during the past down cycle, the advantage afforded to niche/cell captive programmes in purchasing relatively cheap reinsurance, has resulted in the inappropriate use of reinsurance in order to ‘buy down’ cover that would now be expensive to maintain.

Fundamentals

First party cell

The risk that vests in the cell is either retained or part or all of it reinsured. As such, Guardrisk is only liable to pay claims up to a maximum of the share capital, share premium and retained earnings (underwriting results plus investment income) of the particular cell, as well as recoveries from reinsurance purchased. Risk management, underwriting control and capital/reserving are determined by Guardrisk, in conjunction with the broker and the cell owner, as per the “A” shareholder agreement. Premium setting is determined by Guardrisk.

Contingency/rent-a-captive

The client is not an owner of a cell but merely a user. Premiums accrue and claims are incurred within such a facility in the promoter cell. The risk is limited to the premium and the minimum risk layer, which is mostly reinsured. Contingency business written in the promoter’s cell has a risk layer of 20% of GPI, Guardrisk has bought down this exposure to a minimum level, reinsured by a local “AAA” rated insurer.

Third party business

Guardrisk could be exposed to the possibility of defaulting on its policyholder obligations if the cell reported an underwriting loss, the cell owner went insolvent (not being in a position to honour its obligation to maintain the minimum solvency requirements) and the reinsurer defaulted. Risk is therefore greatly reduced, particularly considering the high quality of reinsurers that are employed.

The cell concept was provisionally set up for the express purpose of aftermarket service to the retailer’s customers, as the insurance market was perceived, at the time, to be priced anti-competitively. The cell operates as an independent insurer, with Guardrisk remaining extensively involved in terms of premium quoting, claims submissions, claims assessments and settlements in the majority of schemes. The cost for providing the facility and other insurance services is divided into differentiated service level agreements between the cell, and various organisations within the supply chain and Guardrisk. Given the high proportion of reinsurance, the cell earns reinsurance commission, whilst risk profits/losses are mainly borne by the reinsurers, not the cell. The cell relies on an

acceptable return (investment income, underwriting profit and reinsurance profit commissions, less expenses) on invested capital to support its solvency.

Overall, approximately 60% of premiums are received on an annual basis, providing greater investment opportunity for the cell, whilst the balance is received on a monthly basis. Whilst the majority of business is still sourced from Alexander Forbes (42%), the broker’s contribution has diminished from last year (62%). The five largest brokers now account for 65% of business, implying a reduced level of concentration. In F03, 32% of business was derived from direct selling, compared to 12.4% the previous year.

The benefits of cell captive insurance to cell owners include:

- Greater level of customisation of insurance programs, providing clients with alternative insurance avenues for specialty risks.
- Direct participation in favourable loss ratios.
- Promotes risk control awareness and more selective pooling of risks.
- The lower acquisition costs and the renewable income source.
- Owners are able to partake in any surplus that the cell generates, by way of dividends.
- Claims settlement through procurement and repair is more cost effective within the network (with respect to 3rd party cell).
- Cumulative/pooled investment return benefits.
- Investment income earned by cell owner on premiums paid and surplus funds.

The shortfalls include:

- The lack of substitutability of risks into the pool.
- It is strategically difficult to decline bad risks in volume related business, which is brand related.

Risk Assessment

Industry concentration

The largest concentrations are in the retail sector, which is inherently exposed to changes in interest rates and inflation, and the financial sector. Cognisance is taken of the fact that the largest four clients represented only 20% of GPI.

Industry (%)	2003	
	GPI	NPI
Mining and Resources	7.8	0.0
Industrial	6.5	2.6
Financial	32.5	31.8
Retail	40.0	45.5
Construction	1.6	2.6
Other	11.6	17.5
Total	100.0	100.0

Premium distribution

The spread of risk by class is tabled below. On a gross basis, property accounts for 36% of GPI and motor 32%. Although on a net basis, motor represents a lower 22%, due to the higher net retention of property (41%).

Category (%)	2002		2003	
	GPI	NPI	GPI	NPI
Fire & allied perils	10.0	16.6	36.2	41.1
Marine	8.9	10.7	8.7	10.3
Motor	58.2	47.7	31.9	21.9
CAR/engineering	3.0	3.1	4.6	5.6
Miscellaneous	7.4	8.8	8.7	12.1
Credit/financial risk	0.6	1.1	(0.9)	(0.6)
Accident/liability	11.9	12.0	10.8	9.6
Total	100.0	100.0	100.0	100.0

As evidenced in the table below, the promoter's cell accounts for R743m in GPI and R539m in net premium income ("NPI") in F03, made up mostly of contingency and rent-a-captive business.

Premium (%)	2002		2003	
	Gross	Net	Gross	Net
Promoter's cell	50.5	45.1	54.3	63.6
3 rd party cells	21.1	24.0	25.0	20.0
1 st party cells > R100m	7.3	11.7	0.0	0.0
1 st party cells R50m-R100m	10.4	2.8	8.8	2.6
1 st party cells R10m-R50m	6.0	11.1	7.9	9.1
1 st party cells < R10m	4.7	5.3	4.0	4.7
Total	100.0	100.0	100.0	100.0

Source: management

The 3rd party cells comprise R342m in gross premium (R169m in NPI). In F03, there were no 1st party cells of more than R100m in premium, whilst 1st party cells comprising premium of between R10m and R50m represented 9% of NPI.

Solvency margin

Solvency levels for each cell are calculated monthly, based on a minimum solvency margin of 25% (in terms of compliance).

Solvency margin	2002		2003	
	# of cells	Premium (%)	# of cells	Premium (%)
> 100%	11	11.0	18	20.8
76-100%	3	2.5	3	3.2
51-75%	5	4.9	11	14.9
26-50%*	9	48.7	5	7.2
<25%**	10	7.0	7	27.7
Total	38	74.1	44	73.8

Source: management

* Includes the promoter's cell

** excludes dormant cells

Other than 3rd party cells, Guardrisk does waive this requirement by providing solvency support with the promoter's capital to the degree that the particular cell is able and ready to meet future solvency requirements, relying on the accumulated capital of the promoter's cell to meet the overall statutory solvency requirement.

Across 65 of the cells, representing 74% of net premium, 7 cells are undercapitalised by their owners, from 6 the previous year. The promoter cell's capital provides solvency support in this regard. Around 21 cells are more than adequately capitalised (at over 75%). The overall solvency margin remained in line with F02, at 44%.

Earned loss ratios

The earned loss ratio by cell type reflects a high earned loss ratio of 97% for the promoter's cell, which results from the low earned premiums stemming from contingency business due to high reserves being carried. The 1st party cells recorded a 71% loss ratio (on a net basis), reflecting the significant benefit received from reinsurance. The 3rd party cells generally display lower loss ratios.

Earned loss (%)	2002		2003	
	Gross	Net	Gross	Net
Captive cells (1 st party)	110.0	77.0	40.0	71.0
Promoter's cell	44.0	91.0	74.0	97.0
3 rd party cell 1	78.0	77.0	1.0	30.0
3 rd party cell 2	55.0	55.0	8.0	23.0
3 rd party cell 3	14.0	26.0	40.0	40.0
3 rd party cell 4	33.0	33.0	69.0	70.0

Source: management

Whilst some of the cells are providing for claims incurred but not reported, thus recording substantially higher loss ratios, others have negative loss ratios resulting from either the clawback from reinsurance or downward adjustment of closing outstanding claims.

Earned loss (%)	2002	2003
	# of cells	
Above 121%	6	3
101-120%	4	2
91-100%	1	3
71-90%	6	5
51-70%	7	10
0-50%	27	21
<0%	4	11
Total	55	55

Source: management

Reinsurance

Gerling Re (South Africa) went into run-off in F02. Strategically, the loss of a reinsurance partner limits the competitive pricing options available. Guardrisk has relied extensively on reinsurance in the past, providing high capacity at relatively inexpensive rates to its clients. Given the shrinking capacity in the reinsurance market, the alternative options available to Guardrisk have declined, particularly if a squeeze on the insurance/reinsurance pricing differential arises (which is foreseen given the limited risk appetite of Guardrisk).

The lead international reinsurers (1st party cells) are highly rated, whilst the two local reinsurers (for 3rd party cells) are rated “AAA” and “AA” by GCR. The promoter’s cell is protected by catastrophe cover for each incident.

In 3rd party, Guardrisk’s risk retention relates to two cells. The first relates to a quota share agreement with a “AA” rated local insurer for motor risk, whereby Guardrisk’s retention amounts to 10%. It is noted that this is a continuous treaty, subject to 3 months notice of cancellation to expire on the 31st December any year. Motor material damage catastrophe excess of loss cover is also in place, whereby Guardrisk’s 10% net retention amounts to R120,000 on any one vehicle, limited to R500,000.

The second comprises a 10%:90% quota share agreement on multi peril commercial and personal lines business. A risk and catastrophe combined excess of loss treaty is also in place, limiting Guardrisk’s exposure to R500,000.

Overall, the use of reinsurance has declined over the last three years, to R403m on an earned premium basis. During F03, the company recorded a net benefit of R64m, compared to a loss of R219m in F02 and R342m in F01.

Reinsurance trade off (R'm)	2001	2002	2003
Ceded : proportional	530	237	246
Ceded : non-proportional	221	69	274
Premium ceded	751	306	520
Change in UPR	22	114	(117)
Earned premium ceded	773	420	403
Claims recovered	(388)	(114)	(341)
Change in OCP/IBNR	52	9	(24)
Commission recovered	(94)	(78)	(102)
Underwriting result	343	237	(64)

Solvency and reserving

The benefit afforded to existing cell owners that are facing pricing pressures for larger risks, is to

counterbalance with higher retention limits in the cells. However, this requires capital and the trade-off of paying away more premiums versus capitalising the cell is considered in the current context. The benefit of lower corporate insurance premiums (compared to 7 years ago where corporate tax rates were higher) must be weighed up with the cost of capital, which, with the declining inflationary environment, will become cheaper. However, assuming the higher risk retention going forward (due to higher reinsurance rates), the likelihood of utilising the current conservative claims reserves would depend on the better run-off experience.

Guardrisk’s overall solvency margin declined in F02, from 66% to 44%, mostly the result of the higher retention by the company, as well as the large dividend payments (to “A” shareholders) in F02 (partly relating to the closure of some large cells). In F03, the solvency margin was maintained at 44%, compared to an insurance industry average of around 60%. The financial base has declined from a high of 232% in F00 to 159% in F03, which still remains high compared to the industry average of around 100%, reflecting the continued build up of reserves and provisions.

Investment strategy

The investment assets are managed by Stanlib, Investment Solutions and Sanlam Investment, although the asset management function and investment strategy is overseen by a board sub-investment committee, which comprises largely executive management, but includes non-executive directors. It must be noted that Guardrisk’s role is that of manager only, with investment risk resting with the cell owners. The investment committee ensures adherence to investment parameters set out by the cell owners.

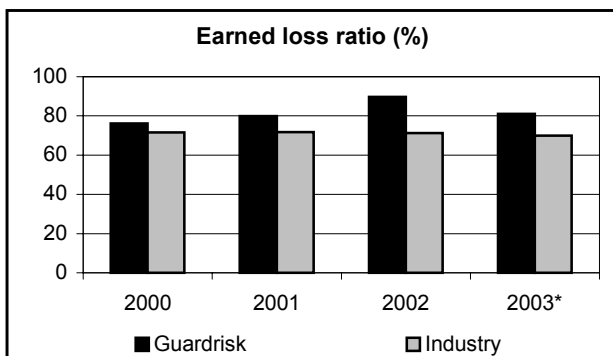
Guardrisk’s investment policy is conservative, with an overwhelming majority of investments in money market and related assets. This policy was considered prudent in F03, given the high interest rate environment that prevailed. In addition, the relatively high liquidity expressed in the 79% allocation to cash and short term investments, ensures that Guardrisk can readily meet its short term liabilities. This is further supported by the cash claims coverage ratio of 32 months. The anticipated reduction in interest rates toward the end of F03, however, resulted in the company increasing the duration of the money market book. Notwithstanding this, an anticipated decrease in investment returns is expected, as with the rest of the industry. The listed equity portfolio represented an insignificant 0.3% of the portfolio in F03.

Asset class	2002	2003
	%	
Cash	23.9	21.9
Short term deposits	60.4	56.9
Preference shares	15.3	20.9
Listed shares	0.4	0.3
Total	100.0	100.0

The guaranteed preference shares relate to Sanlam, Absa and Nedcor, which in addition to providing competitive after tax returns, also builds up STC credits for cell owners. This becomes useful when profits are distributed from the cell in the form of normal dividends. Cognisance must be taken of the fact that no dividends are paid to cell owners/shareholders unless explicitly approved by Guardrisk (after the closure of a cell and also in the normal course of business).

Financial performance

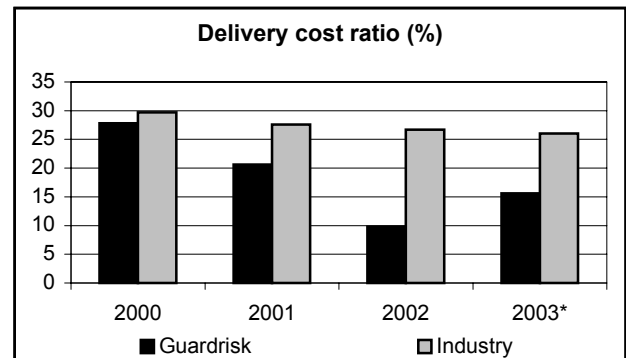
A 5 year financial synopsis is reflected at the end of this report and brief comment follows.



* Insurance industry estimate

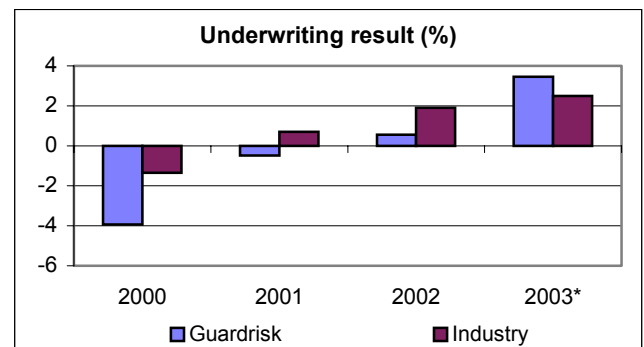
GPI increased by 36% in F03, to R1.4bn. The significantly higher retention ratio of 70% in F02 (F01: 41%), declined to 62% in F03. This led to a 21% rise in net premiums written, to R848m. Given the transfer to the unearned premium reserve, of R181m, Guardrisk's reported a 7% reduction in earned premiums, to R667m in F03. Net claims incurred declined from R642m to R540m, which as a percentage of earned premium amounted to an improved 81%, from a high 90% in F02.

The company's efficiency ratios evidenced a deterioration, from 10% to 15.6% in F03. This was as a direct result of increased administration expenses paid to cell owners, on the back of premium growth. Management expenses as a percentage of earned premium rose to 14% (10%).



* Insurance industry estimate

An underwriting profit was reported for the second consecutive year, of R23m.



* Insurance industry estimate

Investment income of R126m (F02: R112m) equated to an investment return of 8.5% (F02: 8.3%), following the higher interest rate environment and the company's high exposure to money market investments. Overall, an after tax profit of R113m was reported for F03, from R63m last year. Return on average equity improved, from 19% to 33%.

Future prospects

Risks and challenges identified include:

- Reinsurance capacity.
- Pending accounting regulations, which may impact the way in which Guardrisk, and the industry, conduct business.
- Unlike other captive domiciles, there is no specific legislation governing the cell captive industry in South Africa, providing for the legal segregation and protection of the assets and liabilities of each separate participating cell against the promoter cell (commonly known as Protected Cell Companies). Locally, contractual cells are protected by the shareholder agreement and reinsurance contracts. In this regard, extensive reinsurance is purchased by Guardrisk.
- Limited competition in the dedicated cell captive short term insurance market and the resultant threat of new entrants restricting Guardrisk's growth prospects.
- Identifying alternative distribution channels, which poses a challenge to Guardrisk's growth sustainability.

Guardrisk Insurance Company Limited

(R in Millions except as noted)

Year ended : 31 March

	2000*	2001	2002	2003	
Income Statement					
Gross premium income (GPI)	1,342.8	1,278.0	1,006.0	1,367.0	
Reinsurance premiums	(906.0)	(751.0)	(305.0)	(519.0)	
Net Premium income (NPI)	436.9	527.0	701.0	848.0	
(Increase) / Decrease in insurance funds	38.5	(110.0)	15.0	(181.0)	
Net premiums earned	475.3	417.0	716.0	667.0	
Claims incurred	(362.0)	(333.0)	(642.0)	(540.0)	
Commission	(32.0)	(5.0)	3.0	(9.0)	
Management expenses	(100.0)	(81.0)	(73.0)	(95.0)	
Underwriting profit / (loss)	(18.7)	(2.0)	4.0	23.0	
Investment income	144.8	103.0	112.0	126.0	
Other income / (expenses)	0.0	0.0	0.0	0.0	
Taxation	(32.2)	(26.0)	(53.0)	(36.0)	
Net income after tax	94.0	75.0	63.0	113.0	
Unrealised gains / (losses)	(3.0)	(2.0)	(5.0)	(4.0)	
Cash Flow Statement					
Cash generated by operations	(55.7)	103.0	(11.0)	206.0	
Cash flow from investment income	145.0	105.0	112.0	126.0	
Working capital decrease / (increase)	251.1	14.0	302.0	(218.0)	
Cash available from operating activities	340.4	222.0	403.0	114.0	
Tax paid	(29.0)	(53.0)	(36.0)	(34.0)	
Dividends paid	(83.0)	(16.0)	(84.0)	(10.0)	
Cash flow from operating activities	228.4	153.0	283.0	70.0	
Purchases of investments	80.4	(49.5)	(54.0)	(90.0)	
Proceeds on disposal of investments	0.0	0.0	0.0	0.0	
Other investing activities	(0.7)	0.0	0.0	0.0	
Cash flow from investing activities	79.7	(49.5)	(54.0)	(90.0)	
Cash flow from financing activities	13.1	(10.0)	(11.0)	(34.0)	
Net cash inflow / (outflow)	321.2	93.5	218.0	(54.0)	
Balance Sheet					
Shareholders interest	301.3	347.0	310.0	375.0	
Insurance funds	190.0	300.0	285.0	466.0	
Other liabilities	570.0	633.0	943.0	726.0	
Total capital & liabilities	1,061.3	1,280.0	1,538.0	1,567.0	
Fixed assets	2.8	4.0	4.0	4.0	
Investments	134.5	181.0	230.0	314.0	
Cash and short term deposits	887.5	981.0	1,199.0	1,145.0	
Other current assets	36.5	114.0	105.0	104.0	
Total assets	1,061.3	1,280.0	1,538.0	1,567.0	
Key Ratios					
Solvency / Liquidity					
Shareholders funds / NPI	%	86.2	65.8	44.2	44.2
Financial base	%	232.2	227.1	168.2	161.5
Cash flow from operating activities / Liabilities	%	30.1	16.4	23.0	5.9
Claims cash coverage	mths	29.4	35.4	22.4	25.4
Profitability					
ROaE (before unrealised gains / losses)	%	27.6	23.1	19.2	33.0
ROaE (after unrealised gains / losses)	%	26.5	22.5	17.7	31.8
Investment yield (including unrealised gains / losses)	%	12.9	9.3	8.3	8.5
Cash investment yield (average)	%	13.2	9.5	8.7	8.8
Efficiency / Growth					
GPI Growth	%	27.4	19.0	(21.3)	35.9
Premiums reinsured / GPI	%	67.5	58.8	30.3	38.0
Earned loss ratio	%	76.2	79.9	89.7	81.0
Commissions / Earned premiums	%	6.7	1.2	(0.4)	1.3
Management expenses / Earned premiums	%	21.0	19.4	10.2	14.2
Underwriting result / Earned premium	%	(3.9)	(0.5)	0.6	3.4
Operating					
Effective tax rate	%	25.5	25.7	45.7	24.2
Dividend cover	X	1.9	4.7	0.8	11.3

* 15-month period, relevant ratios have been annualised.