

Guardrisk Life Ltd

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South African Insurance Analysis

Security Class	Currency	Rating	Date	Rating Watch	Previous Rating
Financial strength	Rand	A+	10/2003	No	n.a

Rating Rationale

Our rating is based on the following key factors:

- Guardrisk Life Ltd's ("Guardrisk Life") ability to leverage off Guardrisk Insurance Ltd's ten year track record in the domestic cell captive insurance market, its experienced management team and established infrastructure.
- Guardrisk Life's comparative advantage in sourcing and writing cell captive business, in terms of its shareholder and sister company.
- The assurer's conservative approach to underwriting risk and the ring fenced nature of the cell ownership. In this regard, the conservative reinsurance treaties held with highly rated reinsurers were favourably viewed.
- However, in line with the above, the cell captive will experience increasing difficulty in purchasing large, competitively priced reinsurance capacity, given its conservative risk policy and rising reinsurance rates. Accordingly, the need to assume a level of risk for its own account will necessitate a review of the rating.
- Pending accounting regulations, which may negatively impact the way in which Guardrisk Life (and the industry) conducts business.

Capital Structure

The free asset reserves increased, from R24.5m in F02 to R59.7m in F03. The capital requirement increased by 44%, to R8.5m. The capital adequacy requirement has been calculated as though each cell was a separate assurer and then accumulated for all cells. The surplus of assets over liabilities was 7x the capital adequacy requirement, a strong improvement from the 4.2x reported in F02. Non-linked liabilities are either invested in cash or the cells have limited liability clauses (first party cells), therefore a resilience CAR has not been calculated, hence no assumptions were made for a fall in assets. The majority of the capital requirement relates to the mortality, medical and annuity fluctuation CAR item, where it is assumed that the bonus smoothing reserve will be used to offset the fluctuation CAR item (this reduces the capital requirement by just over R3m). The overwhelming majority of the managed investment portfolio is in the form of cash and cash equivalents and money market instruments (almost 60%), depicting a high level of liquidity.

Major Risks

Given increased reinsurance rates worldwide and the company's conservative risk participation strategy, Guardrisk Life may experience increased difficulty in attracting competitive reinsurance rates in the local market. Accordingly, it is the company's intention to begin retaining risk more widely for its net account. The increased scope of assurance underwriting activity could therefore increase the cell captive's business risk profile.

Fundamentals

Guardrisk Life was registered as a life assurer offering cell captive facilities in 1999. The ultimate holding company is the large financial services group Alexander Forbes. In 2002, Alexander Forbes entered into a transaction to dispose of 30% of its local business to Millennium Consolidated Investments (Proprietary) Limited, a black empowerment company.

Company Background

Guardrisk Insurance Company Limited (“Guardrisk”) was granted a license in 1993 and was owned 45% by Alexander Forbes, 45% by Guardian National and 10% by MIB. In 1999, Alexander Forbes’ shareholding in the company increased to 70%, leaving Santam (ex Guardian National) with a lower stake of 30%. During that same period, the ownership structure at Guardrisk was realigned in order to accommodate the newly formed Guardrisk Life Ltd (“Guardrisk Life”). This involved the creation of a holding company, Guardrisk Holdings, with Alexander Forbes and Santam taking up 70% and 30% respectively, with Guardrisk Holdings owning 100% of Guardrisk Insurance and 100% of Guardrisk Life. In 2001, Alexander Forbes acquired Santam’s 30% stake, making Guardrisk Holdings a wholly owned subsidiary of Alexander Forbes. It is estimated that Guardrisk Life has amassed in excess of 50% of the cell market for risk business over this period.

The Guardrisk Life concept is styled on the short term cell captive insurer, which has a ten year track record of cell captive insurance in the domestic market. Whilst the underlying risks are fundamentally different, the objective of efficient risk financing through optimal risk transfer and direct access to reinsurance for cell owners underlies both businesses. The company’s profitability is derived from fee income in excess of management expenses, whilst the profits generated by the cells (investment income and underwriting profits) accrue to the cell owners.

Guardrisk Life, in essence, comprises a single company with individual parts, known as cells, which are kept separate from each other. Each cell is only liable for its own liabilities and not for the liabilities of any other cell within the company. Guardrisk Life’s focus is on post retirement healthcare, credit life and funeral assurance (10% of premiums), disability, fund and group risk business. At present, the company does not retain risk for its net account, however, it is accepted that this will change in the near future, given reinsurance constraints and the extent of capital currently lying idle. During F03, Guardrisk Life participated in underwriting a portion of the reinsurance cover of the largest first party cell, although this reinsurance program expired on 31 March and was not renewed by the cell owner.

The life company has been operational for a full three years, and has grown premium income from R135.6m to R503.4m in this time, translating into a compound growth rate of 93%.

Guardrisk Life offers its clients the advantages of managing their own risk through a group that holds a life assurance license. The capital structure of Guardrisk Life allows for the issue of “L” ordinary shares to clients that wish to establish a particular cell to write “their own business”, while simultaneously adhering to the minimum requirements and criteria laid down by Guardrisk Life. The “L Class” shares are issued to the client at a suitable share premium that will allow the cell to possess the necessary level of capital in order to write business as if such cell was a stand-alone insurer.

Industry Overview

A cell captive allows clients to purchase an equity stake/cell in the promoting company, which undertakes the management of the cell. This includes underwriting, reinsurance, claims management, actuarial and statistical analysis, investment and accounting services. The terms and conditions are governed by the “L” shareholders agreement.

A large number of cell captive insurers have been registered in recent years, most of which operate as appendages of the larger traditional life assurance groups, such as Momentum’s and Old Mutual’s alternative risk transfer businesses. The only other dedicated cell captive is Nova Risk, however, unlike Guardrisk Life, Nova do not have access to a group-owned distribution arm, which is considered an impediment to growing market share. Notwithstanding this, given the recent growth of this market, margins are expected to come under pressure in the near future. Although, Guardrisk Life has built up a strong client base ahead of new entrants, which has been sourced largely from Alexander Forbes and Guardrisk Insurance. This client base has evidenced a relatively high level of stability and loyalty over the three year period.

Operating Structure

Guardrisk Life has a total of 31 corporate clients/active cells (including the promoter cell), from 22 in 2001. Group life clients and post retirement risks that are considered to offer adequate risk spread and sufficient critical mass are being targeted for Guardrisk Life’s range of specialised products. The company offers three principal products/structures to clients, namely first party assurance, third party assurance and the promoter cells. As evidenced in the following table, the first party cells account for a substantial 94% (F02: 91%) of premium income, representing 17 cells (F02: 16 cells).

Gross premium income (%)	2001	2002	2003
First party cells	69.2	90.8	93.9
Third party cells	20.2	8.6	4.3
Promoter cell	10.5	0.6	1.8
Total	100.0	100.0	100.0

First party cells

This represents the majority of Guardrisk Life's business. In this instance, clients utilise the Guardrisk Life cell concept as an efficient mechanism to provide for their own assurance requirements. Risk vests with the cell owner (3 of the 22 cells are fully reassured and thus have no net liability). In terms of standard first party cell structures, there is no risk of Guardrisk Life defaulting on a policyholder obligation because Guardrisk Life is only liable to pay claims up to a maximum of the share capital, share premium and retained earnings (including premiums) of the particular cell, as well as recoveries from reinsurance purchased. In this regard, Guardrisk Life insists on minimum statutory capital adequacy cover, as determined by an independent actuary, for cells which are not fully reassured. Each cell continues to grow its capital base through the life fund, as well as any retained earnings. Before any dividends of particular cells can be declared, the cells must comply with minimum capital and liquidity requirements as determined by the statutory actuary and approved by the board.

Third party cells

Companies utilise the Guardrisk Life cell concept as a mechanism to provide assurance to third parties. In such instances the "insured" is not the cell owner, but the third party (who is the client of the cell owner). In this instance, Guardrisk Life could be exposed to the possibility of defaulting on its policyholder obligations if the cell owner became insolvent (not being in a position to honour its obligation to maintain the minimum solvency requirements) and there were not sufficient funds in the cell to honour future obligations, in the absence of reinsurance cover. In this regard, high quality reinsurers are employed. The cell operates as an independent assurer, responsible for premium quoting, claims submissions, claims assessments and settlements. Given the high proportion of reinsurance, the cell may earn reinsurance commission, but underwriting profits/losses are mainly transferred to the reinsurers, not the cell. The cell relies on an acceptable return (investment income and reinsurance profit commissions, less expenses) on invested capital to support its solvency.

The composition of the 6 third party cells is shown below, with the largest concentration relating to credit life business.

Business	% of 3 rd party GPI	% of total GPI	No. of cells
Credit life	59.6	2.5	2
Funeral	39.1	1.7	3
Disability	1.3	0.1	1
Total	100.0	4.3	6

Promoter cell

The client is not an owner of a cell (hence these are not capitalised cells), but is renting capital from Guardrisk Life. Premiums accrue and claims are incurred within such a facility in the promoter cell. The risk is shared between the client and Guardrisk, who in turn reassures this risk on to its reinsurers. This facility is favoured by mid sized corporates whose business is too small to own its own cell. In F03, a total of 7 promoter cells were in-force, of which three were third party cells, comprising 0.1% of total premium income. The promoter cells comprise 1.8% of gross premium and 4.1% of policyholder liabilities.

Promoter cell	# of cells	% of GPI
1 st party policies	4	1.5
3 rd party policies	3	0.1
Promoter policies	1	0.1
Total	8	1.8

Policyholder liabilities

Policyholder liabilities are weighted predominantly in favor of group life assurance, disability and post retirement healthcare.

Various methods of valuation have been used for the different types of business, which are deemed appropriate by GCR.

Risk Profile

Premium distribution

The five largest clients represent 86% (F02: 82.5%) of total gross premium income, suggesting a high level of concentration risk. The spread of risk across the separately defined industry categories for these five clients is tabled below.

Category (%)	2002	2003
Building and construction	20.9	28.2
Healthcare	28.8	20.4
Electronics	n.a*	19.0
Paper	n.a*	9.6
Commodities	10.2	9.0
Total	59.9	86.2

* Clients gained in F03

Notwithstanding this, these comprise of large and financially sound corporations. During F03, Guardrisk Life lost 1 client (GPI: R0.7m), terminated 2 and gained 6 (R163m).

Capital adequacy requirement

The ratio of free asset reserves to capital adequacy requirement determined by the actuary at balance sheet date for 8 of the 31 registered cells reflected a relatively high range of coverage. According to management, the business written by the remaining cells do not have capital adequacy requirements as these are fully reassured or the bonus stabilisation reserve fully offset the capital adequacy requirement (in 3 instances). The 8 cells represented 24% of gross premiums and 4.8% of policyholder liabilities.

Cells	# of cells	GPI (%)	CAR (R000's)	CAR cover
Fully reassured arrangements				
1 st party cells	15	73.4	n.a	n.a
3 rd party cells	3	0.8	n.a	n.a
Promoter policies	5	1.7	n.a	n.a
Other arrangements				
1 st party cell	1	0.1	58.4	1.09
1 st party cell	1	20.3	5,627.3	2.2
3 rd party cell	1	0.0	464.1	3.52
3 rd party cell	1	1.0	191.7	3.86
3 rd party cell	1	2.6	1,604.8	6.46
Promoter policies:				
1st party	1	0.1	6.5	1.09
3rd party	2	0.0	578.9	n.a*
Total	31	100.0	n.a	n.a

* this cell is not covered by free assets as this has been arranged within a promoter policy and therefore shareholders funds are required to cover the CAR.

Loss making cells

During F03, 6 cells reported technical losses (not related to underwriting) amounting to R482,000, although these losses were easily absorbed by prior year profits totaling R2.3m. The losses related to accounting treatment and to other technical once-off adjustments, and will all be restored by profits in F04. In this regard, it is noted that a risk may arise in the event that a specific cell is prejudiced as a result of a serious error or omission by Guardrisk Life. In order to mitigate such risks, Guardrisk Life reports monthly on the performance of the cells to the individual cell owners, ensuring that if necessary, corrective action is taken swiftly and that a high level of transparency and accountability is evident. In addition, as the administrator of the cell, Guardrisk Life has taken out insurance in this regard.

Underwriting risk

Guardrisk Life is only exposed to underwriting risk in the case of third party assurance, should both the reinsurance arrangements and the client collapse and the business runs unprofitably. In this regard, it is noted that the reinsurers utilised are highly rated and that the client base typically constitutes higher quality corporates in South Africa.

A risk committee (comprising 2 executive and 3 non-executives) meets quarterly, whilst an underwriting committee (which consists of internal management) meets weekly in order to, inter alia, approve new business. The committee is very selective and will only consider approving an existing book of business, which limits the company's risk profile.

Reassurance

Gerling Re (South Africa) has gone into run-off, which is significantly capitalised, accordingly on-risk scenarios are not envisaged. Strategically, however, the loss of a reinsurance partner limits the competitive pricing options available. Guardrisk Life relies extensively on reinsurance, providing high capacity at relatively inexpensive rates to its clients. Guardrisk Life now has fewer alternative options should a squeeze on the assurance/reinsurance pricing differential arise (as foreseen).

Guardrisk Life has no retentions for its net account at present. As such, where a cell is not fully reassured, the cell owner is at risk. Accordingly, the key risk in terms of reinsurance relates to the financial stability of the reinsurer.

Reinsurers utilised include Munich Re, GeneralCologne Re, Hannover Re and RGA Re, which is still fairly new in the market.

Reinsurer	Credit Rating*	Share Capital	CAR cover
Munich Re	A+	R765m	3x
GeneralCologne Re	AAA	R144m	2.7x
Hannover Re	AA-	R35m	1.15x
RGA Re	AA-	R52m	2.5x

* International credit rating

Asset Management

The majority of the asset management function for the company is conducted by Stanlib, although the company also has assets placed with Sanlam Investment Managers and with Investment Solutions, as well as other smaller managers. The respective asset management companies undertake all the administration and portfolio investment functions of

Guardrisk Life, including the externalisation and the safekeeping of funds on behalf of the company, as well as for the cells. This arrangement removes the custody/guardian risk from Guardrisk Life.

The overwhelming majority of the managed portfolio is in the form of cash and cash equivalents and money market instruments, depicting a high level of liquidity.

Other assets comprise insurance policies with Momentum, Metropolitan and Old Mutual. These are linked policies, whose value is dependent upon the investment results of the underlying policies. In addition, these policies are under first party arrangements, so any failure on the policies will reduce the value of the policy in the cell owner's hands. Accordingly, Guardrisk Life is not exposed.

Actuarial Valuation

Actuarial valuations are conducted every six months. The actuarial balance sheet as at 31 March is shown below.

The free asset reserves increased, from R24.5m in F02 to R59.7m in F03. In brief, the capital adequacy requirement is a risk based capital measure that provides a buffer against adverse deviations in actual experience (relating to mortality, investment, lapse and expense experience) compared to expected experience. To demonstrate solvency, an assurer must have an excess of assets over liabilities that covers capital adequacy at least once. The capital requirement increased by 44%, to R8.5m. The capital adequacy requirement has been calculated as though each cell was a separate insurer and then accumulated for all cells. The surplus of assets over liabilities was 7x the capital adequacy requirement, a strong improvement from F02.

Capital adequacy	2002	2003
	R'm	
Net assets	246.9	655.1
Policyholder liabilities	222.4	595.4
Net surplus assets	24.5	59.7
<i>Capital requirements:</i>		
Capital adequacy requirement	5.9	8.5
CAR cover	4.2x	7.0x

Non-linked liabilities are either invested in cash or the cells have limited liability clauses (as in first party assurance), therefore a resilience CAR has not been calculated, hence no assumptions were made for a fall in assets. The majority of the capital requirement relates to the mortality, medical and annuity fluctuation CAR item, where it is assumed

that the bonus smoothing reserve will be used to offset the fluctuation CAR item (this reduces the capital requirement by just over R3m)

Financial Performance

A three year financial synopsis of Guardrisk Life, based on the LT2000 statutory returns up to 2003, is attached at the end of this report and brief comment follows.

Gross premium income increased by 118% to R551.5m, driven by new business volumes and growth in recurring premiums. On a net basis, premium income amounted to R503m, with the cell retention ratio equating to 91% (F02: 91.5%). Investment income of R46.4m was reported (excluding unrealised losses of R1.2m), from R19.2m in F02 (loss of R0.6m), and comprised mostly of interest income (94%). The gross investment yield of 9%, compared favourably to F02 (6%), as did the net investment yield (less expenses), which turned positive, from -2.0% to 0.1%. Total income amounted to R550m for the year (F02: R251m).

Despite the rise in premium income, total claims declined by 48%, without a significant impact on reinsurance, from R184m to R96m. This was ascribed to the significant reduction in surrenders, from R100m to R0.9m. The total claims (including the transfer to the life fund) as a percentage of total income translated to 85.5%, down from 87.5% last year. In terms of the company's efficiency, the management expenses to average premium income (100% of recurring premium and 10% of single premium) ratio improved to 14% (F02: 35%), whilst the commission ratio amounted to 2% (F02; 14%). Relative to the industry (29%), Guardrisk Life compares favourably from an acquisition cost perspective (16%).

The excess of income over outgo amounted to R409m, compared to R42.5m in F02. The company's increasing earnings trend since inception, at a rate of more than 30% per year, has bolstered the capital base, from R18m in F01 to R60m in F03. Furthermore, the company reported a ROaE ratio of 21% in F03, from 7.5% the previous year.

Future prospects

Guardrisk Life's medium term focus is to enhance and retain its technical skills and capabilities. Its focus will remain on its core competencies, namely ART structures for niche and specialist risks. This includes risks that are deemed uninsurable, such as AIDS/HIV. The company also intends leveraging up

its focus on Employee Benefits business going forward.

The benefits of cell captive assurance include:

- Greater level of customisation of assurance programmes.
- Selective pooling of risks.
- Reduce costs and improve benefits for employers and employees.
- Employers/clients wishing to transfer employee benefits off balance sheet.
- Clients are also able to partake in any surplus that the cell generates.

However, risks and challenges identified include:

- Given Guardrisk Life's risk policy, the ability to secure reinsurance is becoming more difficult. Accordingly, the company is to explore the benefits and risks of retaining underwriting risk for its net account in F04.
- Pending accounting regulations, which may negatively impact the way in which Guardrisk Life (and the industry) conducts business.
- Receiving complete, accurate and timely data from cell owners regarding liabilities. This results in the inability to place reinsurance.
- A mismatch of assets and liabilities in any one cell will place Guardrisk Life's capital at risk, particularly in terms of the promoter cells.
- The growing level of competition in the dedicated cell captive life insurance market and the ongoing threat of new entrants.
- Liability arising following the closure of a cell and shareholders funds are insufficient to cover this loss.

GUARDRISK LIFE LIMITED

(R in millions except as noted)

Year end : 31 March	2001	2002	2003	
Revenue statement				
Net premium income	135.6	231.8	503.4	
Life business (including pensions)	(1.2)	90.7	443.8	
Annuities	132.6	132.6	53.8	
Sinking fund	0.0	0.0	0.0	
Funeral business	4.3	8.6	5.8	
Investment income	18.2	19.2	46.4	
Other income	0.0	0.0	0.0	
Total income	153.8	251.1	549.8	
Claims admitted	(32.5)	(60.4)	(76.6)	
Annuities	(99.8)	(22.9)	(18.7)	
Surrenders	(0.1)	(100.3)	(0.9)	
Commission (net)	(11.6)	(6.2)	(4.0)	
Management expenses	(10.0)	(15.4)	(28.8)	
Taxation (paid and provided)	(3.1)	(3.4)	(11.8)	
Other expenses	0.0	0.0	0.0	
Total outgo	(157.3)	(208.6)	(140.7)	
Excess of income:outgo	(3.5)	42.5	409.1	
Add : Unrealised investment surplus/(deficit)	0.0	(0.6)	(1.2)	
Less : Transfer (to)/from policyholder funds	8.3	(35.6)	(373.0)	
Shareholder earnings	4.9	6.4	34.9	
Dividends				
Retained earnings	4.9	6.4	34.9	
Balance Sheet				
Share capital & reserves	17.7	24.5	59.7	
Policyholder funds	186.8	222.4	595.4	
Current liabilities	113.1	53.2	35.4	
Claims provisions (intimated and unintimated)	101.9	36.6	12.7	
Other liabilities	11.2	16.7	22.7	
Total capital and liabilities	317.7	300.1	690.5	
Current assets	5.4	33.8	86.3	
Outstanding premiums and deferred instalments	5.4	33.8	85.0	
Other current assets	0.0	0.0	1.3	
Investments	306.2	222.9	361.4	
Cash on hand + balances at banks	232.6	162.3	326.6	
Government and other stock	27.6	12.7	12.8	
Debentures	0.0	0.0	0.0	
Preference shares	20.1	45.5	20.1	
Ordinary shares	26.0	2.0	1.7	
Corporeal property	0.0	0.3	0.2	
Loans & mortgages	6.1	43.4	242.8	
Other assets	0.0	0.0	0.0	
Total assets	317.7	300.1	690.5	
Valuation statement				
Adjusted value of assets	204.6	246.9	655.1	
Policy liabilities	(186.8)	(222.4)	(595.4)	
Other liabilities	0.0	0.0	0.0	
Excess of assets : liabilities (Free asset reserve)	17.7	24.5	59.7	
Capital adequacy requirement	6.2	5.9	8.5	
Key ratios				
Capital adequacy				
FAR/Policy liabilities	%	9.5	11.0	10.0
FAR/Capital adequacy requirement	X	2.9	4.2	7.0
Premium analysis				
Net premium income growth	%	n.a	71.0	117.1
Single premiums/Total premiums	%	n.a	38.9	44.8
Annual new premiums/Total recurring premiums	%	n.a	6.4	6.4
Outgo analysis				
Benefits paid/Total outgo	%	84.3	88.0	68.3
Benefits paid and provided /Total income (incl. unrealised surplus)	%	80.7	87.5	85.5
Lapses/Annual new premiums (net)	%	n.a.	n.a.	2.2
Lapses/Total recurring premium income	%	n.a.	n.a.	0.1
Surrenders/Total premium income	%	0.1	43.3	0.2
Operating costs				
Commission paid/Average premium income	%	78.3	13.9	1.9
Management & other expenses/Average premium income	%	67.5	34.6	14.0
Investment returns				
Gross investment returns/Average assets	%	n.a	6.0	9.1
Net investment returns/Average assets	%	n.a	-2.0	0.1
Profitability				
ROaE	%	n.a	7.5	20.7