

## Credit Guarantee Insurance Corporation of Africa Limited

South Africa Insurance Analysis

July 2010

Security class	Rating scale	Currency	Rating	Rating watch	Expiry date
Claims paying ability	National	Rand	AA	Yes	07/2011

### Financial data:

(US\$m Comparative)

	31/12/08	31/12/09
R/US\$ (avg.)	8.28	8.44
R/US\$ (close)	9.46	7.42
Total assets	93.5	117.0
Total capital	27.9	33.8
Cash & equiv.	36.7	47.4
GWP	67.9	67.6
U/w result	6.8	(8.9)
NPAT	18.0	3.7
Op. cash flow	24.1	(6.5)

Market cap n.a

Market share\* 75%

\*Estimated share of credit insurance market based on 2009 GWP.

### Fundamentals:

Credit Guarantee Insurance Corporation of Africa Limited ("CGIC") can trace its roots back to 1956, when it was established as a niche insurer, underwriting domestic and export credit risk. The insurer remains firmly entrenched as the niche market leader, leveraging off its size and ability to source extensive credit information for the benefit of its clients. CGIC's major shareholders include Mutual & Federal (53%) and Santam (33%), with the remaining stake split between Munich Re and the Industrial Development Corporation.

### GCR contacts:

**Susan Andrews**

+27 11 784-1771

andrews@globalratings.net

**Melanie Brown**

+27 11 784-1771

brown@globalratings.net

**Website:** www.globalratings.net

### Rating rationale

The rating is based on the following key factors:

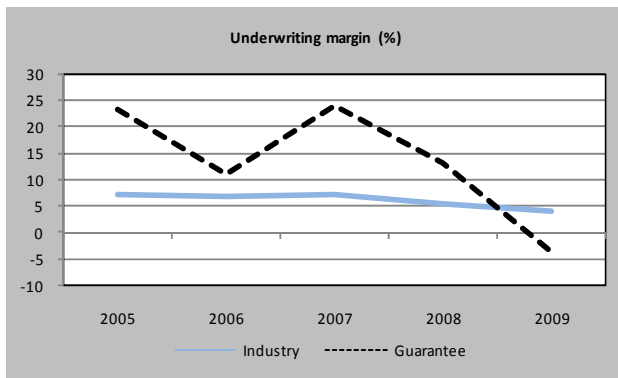
- CGIC's dominant position in the credit guarantee market, as well as its long track record and highly experienced management team. Furthermore, CGIC's extensive credit information database and systems capabilities are considered a competitive advantage.
- The insurer is highly exposed to the credit cycle, as illustrated by the underwriting loss registered in F09. Cognisance is, however, taken of the corrective measures that were implemented, which supported a turnaround in performance towards the end of F09 and into 1H F10.
- A series of large dividend payments has resulted in a marked contraction in the capital base, with international solvency declining consistently since F06, and a further decline forecast in F10. At present, management's targeted solvency band is between 50% and 75%. GCR would consider a solvency margin of not less than 70% as being appropriate for the current rating band, given the sizeable exposure to equity investments and the increase in risk retention.
- The insurer has actively reduced its exposure to equity markets in the past two years; however, at 83% of capital it remains high and increases capital risk significantly. Claims cash coverage remained adequate, although was impacted by the unprecedented increase in loss experience in F09.
- Cognisance is taken of the high commercial default rate, which has persisted into 2010 and could continue to pressurise margins in the credit guarantee segment of the market.

### Solvency & liquidity

Net of the R28m dividend declared in 1H F10 (in respect of F09 earnings), shareholders funds decreased by 5% to R251m at FYE09. This was offset by a decrease in premium retention, with the international solvency margin registering at 72% in F09 (F08: 71%), albeit remaining well below historical levels. The insurer continued to reflect conservative reserving ratios, with the financial base ratio reported at a high 190% in F09 (F08: 174%). The 2010 XOL treaty retention was increased to R30m from R15m previously, which equated to a high 12% of FYE09 capital. The largest gross exposure amounted to R750m at year end F09, net of the policyholder risk participation and assuming that 35% of the gross limit is utilised. Management confirms that special limits would be secured for risk exposures that exceed the proportional treaty limit, bringing the net retention in line with the treaty retention level.



## Industry overview



Note: 2009 underwriting margins are based on GCR estimates.

CGIC specialises in the provision of trade credit insurance, and its underwriting performance generally follows that of the other large players in the guarantee class. Guarantee business has traditionally been highly profitable relative to the overall industry average, which is attributed to the specialised nature of this type of business and limited number of participants in the market. However, the performance of the guarantee class is highly correlated with the credit cycle, and is subject to a greater degree of volatility. The global recession triggered a substantially higher incidence of commercial defaults in 2009, which placed significant pressure on both premium volumes and underwriting profitability in this segment. Accordingly, the guarantee class noticeably underperformed relative to the more diversified industry players in terms of underwriting profitability in 2009. Despite the fact that South Africa is officially out of the recession, consumer spending is expected to remain relatively subdued, while a lag in business insolvencies is likely to feed through into 2010. Accordingly, credit insurers' underwriting margins are expected to remain relatively pressurised in the near term, albeit to a lesser extent than in 2009.

### Competitive positioning

	Coface ZA		CGIC	
	F08	F09	F08	F09
GWP (R'm)	139.9	136.0	562.3	570.9
NWP (R'm)	68.0	40.4	374.7	350.9
Retention	48.6	29.7	66.6	61.5
Earned loss	68.2	83.6	64.6	98.7
Deliv. cost ratio	37.1	37.5	19.7	21.3
U/w margin	(5.3)	(21.0)	15.7	(20.1)
Int. solvency	49.4	124.4	70.5	71.5
Stat. solvency	32.1	48.2	58.3	62.4
Cash cover	35.1	45.1	18.0	11.5

CGIC has been operating as a specialist credit insurer for more than fifty years and has built up a substantial debtor database spanning more than 100,000 companies across a broad spectrum of industry segments. The insurer is the dominant player in the credit guarantee class, with a market share of

approximately 75%. CGIC mainly competes with Coface ZA, which is the only other player in the market to exclusively focus on credit insurance.

The substantial underwriting losses posted by both insurers are a reflection of the extremely challenging underwriting environment in F09. CGIC's relative size provides it with noticeable efficiency benefits, which have historically bolstered underwriting profitability relative to the industry and its competitors. Furthermore, the insurer has tended to reflect a more favourable earned loss ratio (averaging 59% over the review period, versus 67% for Coface ZA), facilitated by the high degree of diversification in the portfolio, and a focus on appropriate pricing. However, in F09, a delay in implementing corrective measures saw the loss ratio deteriorate substantially relative to that of its competitor. Following an active decision to lower earnings retention and improve the return to shareholders, CGIC's international solvency margin has declined noticeably over the review period, and fell below that of Coface ZA in F09. Cognisance is, however, taken of the high degree of diversification in terms of exposures, as well as the insurer's conservative approach to reserving. Both insurers reflected a comfortable cash coverage ratio relative to the market.

### Risk management

CGIC monitors the credit quality of underlying debtors on an ongoing basis, with each industry segment falling under the mandate of a dedicated underwriting manager. If there is a deterioration in default probability relating to an underlying buyer, the insurer is able to reduce exposure limits to manage the potential claims severity associated with the company. However, the preferred approach is to ensure that pricing is commensurate with risk exposures in a particular client portfolio, and premium changes can usually be effected subject to 30 days notice, given the low proportion of annual contracts (around 3% in F09). In the event that a claim is paid by CGIC, the insurer has the right to make recoveries on the liquidation of the debtor, with salvages averaging between 10% and 15% of claims paid. In this regard, various forms of collateral are accepted, with the value and nature of the security varying according to the size of exposure and credit quality of the buyer. The client normally retains a portion of the risk for its own account, which aligns interests and promotes better risk management by the policyholder. Lower claiming clients are entitled to a performance bonus, which also encourages more stringent risk management by the policyholder.

During the second half of F09, CGIC strengthened its risk management in response to the substantially higher default rate. Specific measures included across the board premium increases (effected by October

F09 for most clients), as well as a review of policies that had exposures that were identified as being problematic. Increased emphasis was placed on strengthening the salvage and mitigation functions, to identify problem accounts more quickly and maximise claims recoveries.

### Risk diversification

In light of the more severe recessionary environment in international markets, CGIC's export credit insurance premiums declined by 37% to R79m in F09, and accounted for a lower 14% of GWP (F08: 22%). The insurer sourced the majority of business via brokers in F09, with the balance derived directly. Given the nature of the business, it tends to be dominated by the more established intermediaries. The book was well diversified in terms of clients, with the five largest companies contributing a combined 3% of GWP in F09.

In terms of underlying debtor exposures, the corrective measures that were implemented in F09 saw the total of gross exposure limits decrease to 76.5bn at FYE09 from R80.8bn at the end of F08. These were spread across 120,000 buyers, down from 126,034 in F08. The five largest exposure limits accounted for a combined 8% of cumulative approved gross exposure limits. In general, the policyholder participates in between 10% and 20% of the risk, and debtors utilise between 30% and 35% of the approved limit. Management monitors larger sized exposures on a weekly basis, and confirms that special limits would be secured from reinsurers for exposures that are expected to exceed the treaty limit on a permanent basis. The industry mix remained relatively stable in F09, with the largest concentration being to the retail sector, followed by metal & machinery manufacture. The construction and wholesale segments are the next largest, with the balance of the book being relatively well spread amongst other industry segments.

### Reinsurance

The main reinsurers on CGIC's reinsurance treaties include Munich Re, Hannover Re, Swiss Re and SCOR. A quota share treaty reduces proportional risk participation to 75%, with total capacity limited to R500m. The insurer increased the attachment point under the XOL treaty to R30m from R15m in F09, which represented a substantially higher 12% of FYE09 capital (previously 6%).

Given the increase in gross claims experience, CGIC derived a R34m net recovery from the reinsurance market in F09 (F08: R70m net transfer). This notwithstanding, the trade-off has generally favoured the reinsurers, as demonstrated by their comparatively low loss ratios. In line with a

hardening of international credit reinsurance rates and limited capacity, the premium rates on CGIC's 2010 XOL treaty have been adjusted upwards, while the commission rate on the quota share programme was reduced.

Table 2: Reinsurance (R'm)	Earned		Cash	
	F08	F09	F08	F09
Premium ceded	(193.9)	(216.1)	(187.5)	(220.0)
Claims recovered	112.2	233.5	67.8	210.3
Reins. share of salvage	(51.8)	(38.5)	(44.4)	(24.4)
Comm. received	63.7	54.6	63.7	54.6
<b>Net result</b>	<b>(69.8)</b>	<b>33.6</b>	<b>(100.4)</b>	<b>20.5</b>
<b>Ratios (%)</b>				
Reins. salv : total salv	44.1	35.6	50.4	34.9
Reins. claims ratio	31.2	90.2	12.5	84.5

### Asset management

Table 3: Investments	F08		F09	
	R'm	%	R'm	%
Cash & equivalents	346.9	53.4	351.7	59.7
Listed shares	268.8	41.3	207.2	35.2
Listed prefs	19.6	3.0	19.5	3.3
Gov. securities	3.3	0.5	2.1	0.4
Forex investments	11.5	1.8	9.0	1.5
<b>Total</b>	<b>650.2</b>	<b>100.0</b>	<b>589.5</b>	<b>100.0</b>

CGIC continued to reduce its exposure to listed equity investments, and disposed of shares valued at R101m in F09. After accounting for fair value gains of R39m, the value of listed equities decreased by 23% to R207m and constituted a lower 35% of the overall investment portfolio (F08: 41%). However, listed equities represented 83% of shareholders interest at FYE09, which is still considered aggressive. Investment proceeds were largely offset by a R74m operating cash absorption, with cash and equivalents remaining fairly flat at R352m in F09. Following a 59% increase in net claims, the claims cash coverage ratio contracted sharply, to 12 months from 18 months in F08. The investment mix is expected to remain relatively stable in the near term, and management has set its maximum equity exposure benchmark to between 80% and 90% of capital (previously around 150%). This still implies a high degree of capital risk.

The insurer unwound a derivative hedging instrument in October F09, which resulted in a R30m realised loss. Combined with lower dividend receipts, this drove a 22% contraction in investment income, to R55m in F09. This was partly mitigated by the improved performance of the equity portfolio, with the total investment yield increasing to 6%, from negative 8% in F08.

The absence of derivative protection has increased CGIC's exposure to equity market risk. At FYE09, it was calculated that a 10% reduction in the value of

listed equities would result in an approximate R22.6m decline in NPBT. This compares to a R9m reduction in profit before tax in F08 under the same scenario, but with a higher exposure to listed equities.

### **Solvency and reserving**

---

Following a series of large dividend payments (cumulatively totalling R886m over a four year period), shareholders funds decreased consistently between F05 and F08, and amounted to R264m at FYE08 (F05: R416m). Net of a R28m dividend payment in 1H F10 (declared in respect of F09 earnings), shareholders funds decreased by 5% to R251m at FYE09. This notwithstanding, following a decrease in average retention, the international solvency margin remained relatively stable at 72% (F08: 71%).

Based on preliminary work on an internal risk based capital model, management believes that capital should equate to approximately 65% of NPE. This implies a comfort level of approximately R270m based on F10 earned premium projections, leaving very little scope for distributions to shareholders. Cognisance is taken of the fact that this model is in its early stages and has not yet been embedded in the business or adequately tested. Progress with the internal capital model is considered a key priority by management, given the need to develop a dividend policy that is more in line with the cyclical nature of the business and with future regulatory requirements. At present, management's targeted solvency band is between 50% and 75%, depending on reinsurance structuring and the composition of the investment portfolio. GCR would consider a solvency margin of 70% as being more appropriate in the near term, given the exposure to equity investments and the increase in risk retention, as well as the adverse claims environment.

The statutory funding ratio advanced by four percentage points to 62% in F09, and remained well above the minimum regulatory requirement. The main difference between the statutory and international solvency margins (aside from the classification of contingency reserves) related to the deferred tax asset of R30m, which was excluded from F09 net surplus assets for statutory reporting purposes.

The financial base ratio rose to 190% from 174% in F08, underpinned by the increase in claims reserving and higher net surplus assets. This includes R60m in reserves relating to discontinued reinsurance inwards operations, which are in runoff. A breakdown of claims runoff patterns indicates that the insurer has followed a prudent approach in terms of claims reserving, with adjusted estimates having been at

least 15 percentage points below original estimates over a five year underwriting period (up to 2008).

### **Financial performance**

---

A five year summary of CGIC's financial performance is reflected at the end of this report, and brief comment follows.

CGIC prepared a revised forecast in July F09, following the significant deterioration in the operating environment and adverse impact on claims experience. Actual GWP was slightly ahead of expectations, while the earned loss ratio ended the year below budget. Furthermore, the absence of performance bonus payments assisted in containing management expenses below forecast levels. Accordingly, the underwriting loss of R75m was less severe than initially anticipated.

GWP increased by only 2% to R571m in F09, which was ascribed to subdued growth in underlying corporate activity and more cautious risk selection. An increase in XOL reinsurance premiums resulted in a 6% contraction in NWP, despite the stable quota share retention ratio. The auditors recommended a reduction in the loading percentage applied for low claims bonuses (over and above the risk premium rate), which was the primary driver of the R22m net release of UPR in F09. This supported 4% growth in earned premiums for the year.

Driven by an unprecedented increase in claims frequency, the gross loss ratio (including provisions and net of salvage income) increased to 93% from 55% in F08. The earned loss ratio rose to 99% from 65% previously, with F09 being one of the worst claiming years in CGIC's history. Net commission income declined by 33% to R18m, owing to an adjustment in the average reinsurance commission rate. Despite well contained management expenses, the delivery cost ratio increased to a review period high of 21% (F08: 20%). This nonetheless remained well below the industry average of around 30%. Overall, the deterioration in commission and claims ratios resulted in a substantial underwriting loss of R75m, representing the first negative result in nine years. Cognisance is taken of the turnaround in performance during the second half of the year, which reduced the overall underwriting loss relative to 1H F09. This followed the more stringent controls and underwriting practices that were implemented towards the latter part of the year.

After accounting for a decrease in realised investment gains and R51m in fee based income, NPAT contracted by 79% to R31m in F09. Including unrealised investment movements, ROaE contracted to 6% from 11% in F08. This compares to an average of around 57% between F05 and F07.

## **Future prospects**

---

To date, actual performance has improved substantially relative to F09, with the earned loss ratio registering at 65% in 1H F10 versus 99% in F09. The insurer posted an underwriting profit of R14m at the interim, versus a substantial loss position in 1H F09.

Management has prepared revised forecasts for the full year F10, based on actual performance for the year to date. GWP growth is projected to increase to 20% in F10, largely on the back of premium adjustments and a small component of new business. The increase in the XOL deductible is expected to raise average premium retention to 66% for F10 (F09: 62%). A reduction in reinsurance commission rates is likely to place pressure on the net commission line. Combined with a R25m incentive bonus provision, this is expected to see an increase in the delivery cost ratio, to 23% from 21% in F09. The improvement in loss experience is expected to underpin a strengthening in underwriting profitability, albeit well below historical levels. Cognisance is taken of the anticipated reduction in the international solvency margin, following further profit distributions to shareholders.

# Credit Guarantee Insurance Corporation of Africa Limited

(R in Millions except as noted)

Year ended : 31 December	2005	2006	2007	2008	2009	
<b>Income Statement</b>						
Gross written premium (GWP)	436.9	458.1	491.7	562.3	570.9	
Reinsurance premiums	(192.7)	(162.3)	(163.6)	(187.5)	(220.0)	
<b>Net written premium (NWP)</b>	<b>244.2</b>	<b>295.9</b>	<b>328.1</b>	<b>374.7</b>	<b>350.9</b>	
(Increase) / Decrease in insurance funds	(2.2)	(2.2)	(3.6)	(16.6)	21.8	
<b>Net premiums earned</b>	<b>242.0</b>	<b>293.7</b>	<b>324.5</b>	<b>358.1</b>	<b>372.7</b>	
Claims incurred	(82.7)	(103.7)	(151.0)	(231.3)	(367.8)	
Commission	46.6	33.2	26.4	27.2	18.2	
Management expenses	(77.9)	(88.6)	(91.2)	(97.6)	(97.8)	
<b>Underwriting profit / (loss)</b>	<b>128.0</b>	<b>134.6</b>	<b>108.7</b>	<b>56.4</b>	<b>(74.7)</b>	
Investment income	138.0	136.7	204.4	69.6	54.6	
Other income / (expenses)	39.5	41.9	42.9	45.9	51.0	
Taxation	(101.9)	(102.0)	(80.3)	(22.8)	0.2	
<b>Net income after tax</b>	<b>203.7</b>	<b>211.2</b>	<b>275.7</b>	<b>149.0</b>	<b>31.0</b>	
Dividends paid / declared	(260.7)	(262.5)	(297.7)	(65.5)	(28.0)	
Unrealised gains / (losses)	51.6	26.0	(95.3)	(119.7)	(16.4)	
<b>Balance Sheet</b>						
<b>Shareholders interest</b>	<b>415.6</b>	<b>395.1</b>	<b>277.9</b>	<b>264.3</b>	<b>251.0</b>	
Net UPR	67.7	65.5	68.1	81.0	59.2	
Net OCR and IBNR	196.7	217.9	233.7	358.0	364.1	
Other liabilities	165.5	176.5	154.3	181.1	194.1	
<b>Total capital &amp; liabilities</b>	<b>845.5</b>	<b>855.1</b>	<b>733.9</b>	<b>884.4</b>	<b>868.4</b>	
Fixed assets	29.7	36.4	38.0	67.8	66.8	
Investments	532.7	528.2	420.3	303.2	237.8	
Cash and short term deposits	129.3	129.1	141.3	346.9	351.7	
Other current assets	153.7	161.4	134.3	166.3	212.1	
<b>Total assets</b>	<b>845.5</b>	<b>855.1</b>	<b>733.9</b>	<b>884.4</b>	<b>868.4</b>	
<b>Key Ratios</b>						
<b>Solvency / Liquidity</b>						
Shareholders funds / NWP	%	170.2	133.6	84.7	70.5	71.5
Statutory solvency	%	158.3	121.3	65.6	58.3	62.4
Net UPR / NWP	%	27.7	22.1	20.7	21.6	16.9
Net outstanding claims / NWP	%	80.6	73.6	71.2	95.5	103.8
Financial base	%	263.5	215.8	155.0	173.7	189.8
Claims cash coverage	months	18.8	22.4	11.2	18.0	11.5
<b>Profitability</b>						
ROaE (before unrealised gains / losses)	%	48.1	52.1	81.9	55.0	12.0
ROaE (after unrealised gains / losses)	%	60.3	58.5	53.6	10.8	5.7
Investment yield (incl. unrealised gains / losses)	%	27.7	24.7	17.9	(8.3)	6.2
Investment yield (excl. unrealised gains / losses)	%	20.2	20.7	33.5	11.5	8.8
<b>Efficiency / Growth</b>						
GWP Growth	%	(35.6)	4.9	7.3	14.3	1.5
Premiums reinsured / GWP	%	44.1	35.4	33.3	33.4	38.5
Earned loss ratio	%	34.2	35.3	46.5	64.6	98.7
Commissions / Earned premiums	%	(19.3)	(11.3)	(8.1)	(7.6)	(4.9)
Management expenses / Earned premiums	%	32.2	30.2	28.1	27.3	26.2
Underwriting result / Earned premiums	%	52.9	45.8	33.5	15.7	(20.1)
Trade ratio	%	47.1	54.2	66.5	84.3	120.1
Operating ratio	%	(9.9)	7.6	3.5	64.8	105.4
<b>Operating</b>						
Effective tax rate	%	33.3	32.6	22.5	13.3	n.a
Dividend cover	x	1.0	0.9	0.6	0.4	(0.5)