

## **METHODOLOGY FOR THE PREPARATION OF CREDIT RATINGS OF PENSION INSURANCE COMPANIES**

The ratings of the pension funds of pension-insurance companies present an appraisal from the viewpoint of the insured persons. Pension-insurance companies have different transparency of their activity, different management practices, differences in their accounting practices, and in their practices for appraisal of assets and for safe-appraisal of their investment activity. The ratings of the pension funds present independent appraisals following the same methodology. The latter eliminate the information asymmetries and reduce the problems insured persons have in their choice of a fund (related to the above-stated differences).

There exist two types of pension-insurance schemes:

- pension-insurance schemes with defined installments. Under such schemes, the obligations of the pension-insurance company to the insured persons is limited to the amount of the installments made, and to the yield achieved from the investment activity. At present, the pension-insurance schemes with defined installments are the only legally allowed pension schemes in Bulgaria. For pension funds acting on the principle of defined installments, the rating presents an appraisal of the quality of their investment activity and the quality of their management.
- pension-insurance schemes with defined pensions. With such funds, the amount of the obligation of the pension-insurance company to the insured persons is determined in advance. The now effective legal framework in Bulgaria does not allow the existence of such pension schemes. The rating of a fund under such scheme would be very similar to the classical debt rating, and would assess the ability of the pension-insurance company for timely meeting its financial liabilities.

### **ANALYTICAL FRAMEWORK**

The determination of the rating of a pension-insurance company consists of analyses made in the following directions: legal framework of the pension insurance, appraisal of the investment activity, financial analysis (with respect to liquidity, in the first place) and analysis of the quality of management.

## **LEGAL FRAMEWORK OF THE PENSION INSURANCE**

The pension insurance is an industry strongly regulated. According to the fair and conservative practices, regulation plays an important role for the functioning of the pension-insurance companies and the funds managed thereby, as well as for the control of the activities thereof. The influence of the legal requirements (compliance inclusive) on a given pension fund is an important factor for its appraisal.

## **INVESTMENT QUALITY**

The pension funds may invest in capital and debt instruments; market risk exists for both types of investment, and Credit Limit for the second type. BCRA assesses the investment portfolios of the pension funds, assuming a mixed approach – downward (the analysis starts with the state of the economy) and upward (the analysis starts with the separate exposures). Thus, the overall quality of the investment portfolio is assessed. Investment portfolios are assessed also from the viewpoint of their liquidity, taking into consideration the structure of cashflows of the pension funds at the time being, as well as in the near future. In case a considerable concentration of the portfolio exists, BCRA makes a fundamental analysis of the biggest capital and debt exposures.

The liabilities of the pension funds have a much longer maturity than the duration of the respective portfolio. Such difference creates a risk for the insured persons, ensuing from changes in the interest rate. The Credit Limit Risk of the investment portfolio is another major risk factor.

Capital investments are reviewed in the context of their expected yields; the system risk is reviewed from the point of view of the volatility of the capital investments (resulting from changes in the economic environment). BCRA takes a positive attitude at well-diversified (in different sectors) portfolios, with low concentration of the separate exposures. The portfolios of pension funds are featured by certain dynamics, for which reason it is important to investigate the existing policies and practices with respect to entry into/leaving a position, and with respect to the existing system for risk management.

The investment policy is being analyzed from the viewpoint of the manner of forming of the portfolio, with respect to exposures, by types of instruments, industries, regions, etc. The consistency of the investment policy in time is being traced, and the objectiveness of the investments made is being assessed.

## FINANCIAL ANALYSIS: APPRAISAL OF LIQUIDITY

The rating of a pension company also reflects its ability to timely meet its financial liabilities to the insured and retired persons. Related to this, the current liquidity of the company is assessed.

The incoming cashflows of the secured persons reduce liquid risk. Pension-insurance companies receive periodical installments from the insured persons. The possible delay of payments, the bankruptcy of any of their large corporate clients, or the inability to pay the pension installments on part of a large number of secured persons are regarded as potential risks. For this reason, BCRA has a positive attitude at large, well-diversified (both geographically and by business sectors) bases of secured persons.

## APPRAISAL OF THE MANAGEMENT

BCRA believes that the good operating procedures and systems for control are of key importance for the success of the pension funds, in the long run. BCRA analyzes the pension-insurance companies for factors, which would possibly hinder the effective and timely taking of decisions; for factors, which could restrict the capabilities of the Company to find and react to the risks already existing, and for factors, which could obstruct the effective and quality service of clients. The organizational structure, and the spending structure borne thereby, is also reviewed. The competency of the management, the individual members of the management, and the existing continuity, are the other important factors for the success of both the pension-insurance company and of the funds managed by it.

## RATING SCALE FOR A PENSION-INSURANCE COMPANY

### LONG-TERM RATING

AAA	Exclusively high capability for timely meeting the liabilities. Substantial financial stability. Excellent prospects for development. Exclusively low credit risk.
AA	Very high capability for timely meeting of the liabilities. Substantial financial stability. Very low credit risk.
A	High capability for timely meeting of the liabilities. Weak vulnerability to unfavorable changes in the business or economic environment. Financial stability. Low credit risk.
BBB	Fair capability for timely meeting the liabilities. Fair financial state. Vulnerability to unfavorable changes in the business or economic environment. Moderate credit risk

BB	The meeting of the liabilities is to a large extent influenced by the unfavorable changes in the business or economic environment. The financial state is relatively fair. Unsteady trend of development. There exists credit risk.
B	High extent of insecurity relating to the financial stability and capability for redeeming the liabilities. Strong vulnerability to unfavorable changes in the business or economic environment. High credit risk.
CCC	Unfavorable changes in the business or economic environment may bring to a considerable deterioration of the state of the Company, and further lead to incapability for redeeming of the liabilities. Weaknesses in the financial state. Considerable credit risk.
CC	There exists considerable risk of going into insolvency. Substantial problems in the financial state.
C	Very high risk of going into insolvency. Very weak financial state.
D	The Company is insolvent and/or is in a procedure of being stated in insolvency.

**Note:** The symbols „+” and „-” of the rating (categories AAA and D exclusive) are used to represent the relative creditworthiness within a single rating category

**Prospects:**

**Positive** – reflecting expectations for passing into an upper category rating within 1 year

**Negative** – reflecting expectations for passing into a lower category rating within 1 year

**Stable** – reflecting expectations for keeping of the rating category within 1 year

**In development** – reflecting expectations for the occurrence of an event, which may have negative/positive influence on the rating category

**SHORT-TERM RATING**

A-1+	The highest short-term rating. Excellent capability for timely meeting the liabilities. Very low credit risk.
A-1	High capability of timely meeting the liabilities. Weak vulnerability to unfavorable changes in the environment. Low credit risk.
A-2	Relatively high capability for timely meeting of the liabilities. Vulnerability to changes in the environment. Relatively low credit risk.

A-3	Fair capability of timely meeting the liabilities. Vulnerability to changes in the environment. Moderate credit risk.
B	Satisfactory capability of meeting the liabilities, and strong influence of the unfavorable changes in the environment. Relatively high credit risk.
C	Low capability for redeeming the liabilities and high dependence on the unfavorable changes in the environment. Substantial problems in the financial state. Risk of going into insolvency.
D	The Company is insolvent and/or is in a procedure of being stated in insolvency.

The short-term rating reflects the possibility of serving the short-term/current liabilities (within one year)

#### **RATING SCALE FOR A PENSION FUND**

Rating	Comments
AAA pf	Excellent management and operating practices. Excellent investment policy and investment portfolio.
AA pf	Very fair management and operating practices. Very fair investment policy and investment portfolio.
A pf	Fair management and operating practices. Fair investment policy and investment portfolio.
BBB pf	Satisfactory management and operating practices. Satisfactory investment policy and investment portfolio.
BB pf	Unsatisfactory management and operating practices. Unsatisfactory investment policy and investment portfolio.
B pf	Weak management and operating practices. Weak investment policy and investment portfolio.
C pf	High-risk management and operating practices. Weak investment policy and investment portfolio.