



Credit Rating Announcement

GCR affirms Fedhealth Medical Scheme's national scale financial strength rating of AA-(ZA); Outlook Stable

Rating Action

Johannesburg, 21 October 2019 – GCR Ratings (“GCR”) has affirmed Fedhealth Medical Scheme’s (“Fedhealth”) national scale financial strength (formerly claims paying ability) rating of AA-(ZA), Stable Outlook.

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook/Watch
Fedhealth Medical Scheme	Financial strength	National	AA-(ZA)	Stable Outlook

GCR announced that it had released new criteria for rating insurance companies in May 2019. Consequently, the rating for Fedhealth was placed 'Under Criteria Observation'. GCR finalised the review for Fedhealth under the released Criteria for Rating Insurance Companies, May 2019. As a result, the rating for Fedhealth has been reviewed in line with the new methodology and subsequently removed from 'Under Criteria Observation'.

Rating Rationale

Fedhealth's rating is underpinned by a strong financial profile (a function of strong solvency, sound liquidity and adequate earnings), which is offset by an aged member base and moderate market position. The rating also factors in the recent amalgamation between Fedhealth and Topmed Medical Scheme. Topmed Medical Scheme (“Topmed”) is a small sized scheme which exhibits very strong solvency, albeit with exposure to high earnings risk under the current operating model. In this regard, the on boarding of this scheme will strengthen solvency over the short term, while enhancing member scale, although these could be counterbalanced by higher claims (noting slight age creep for the combined scheme) and operating costs, with the combined impact supporting a stable credit profile over the medium to longer term.

Solvency is strong, with the statutory solvency margin sustained above 31% over the past four years (FY18: 31.4%). The recent amalgamation with Topmed Medical Scheme is expected to add an additional R521m in reserves to the scheme, with the statutory solvency margin for the combined scheme budgeted at 41.4% for FY19. However, forward looking projections indicate that the combined scheme's solvency will gradually reduce to FY18 levels over the longer term, which is broadly in line with the scheme's solvency management strategy of preserving an adequate buffer above the minimum regulatory requirements to compensate for claims variability. As such, GCR expects solvency strength to be maintained over the rating horizon, with the long term statutory solvency margin likely to trend within a range of 28% to 32%.

Sound liquidity is supported by healthy stressed liquid asset coverage of average monthly claims. Going forward, the combined scheme's liquidity metrics are expected to be slightly stronger given the sizeable transfer of reserves (relative to associated costs). Nonetheless, cash generative capacity will be a key consideration in sustaining elevated metrics, particularly in view of expected claims and cost pressures.

The scheme's earnings are viewed to be adequate and sufficient to support targeted solvency levels. In this regard, while the claims ratio has historically trended above the industry average, the scheme has demonstrated an ability to implement comparatively higher contribution rate increases when required (FY18: 8.74%; FY17: 13.4%; FY16: 10.8%) in order to replenish reserves. Further to this, over the past two years, targeted claims management initiatives have seen a lowering in the claims ratio (FY18: 89%; FY17: 87%; prior three year average: 92%). Nonetheless, post the amalgamation, GCR is of

the view that the combined scheme may evidence some claims deterioration. While management projections are for an average claims ratio of 87% over the next three years, GCR believes that it is more likely that the claims ratio may trend in line with historical levels (i.e. above 90%), supporting an adequate forward looking earnings assessment.

The aged membership profile is negatively viewed, with the average beneficiary age and pensioner ratio of the combined scheme projected at a high 39.3 years and 15.5% respectively for FY19. The amalgamation is expected to result in slight age creep, although the impact is moderated by enhanced scale, with market share expected to increase to around 3.7% in FY19 (FY18: 3.1% standalone Fedhealth market share). Going forward, the integration of Topmed members onto Fedhealth's option structure would need to be carefully managed as potential member movement to lower tier options may negatively impact earnings. Furthermore, Fedhealth also redesigned its options structure in FY19, which may unsettle a portion of existing members and could lead to some variability in member levels over the short to medium term, although the scheme is expected to maintain its increased market position over this period.

Outlook Statement

The Stable Outlook reflects expectations that the scheme's credit profile will continue to be underpinned by strong solvency and sound liquidity, with these strengths being offset by the aged member profile which could result in earnings pressure.

Rating Triggers

Positive rating movement could develop if the scheme's earnings capacity sustainably improves whilst maintaining strong levels of solvency. Conversely, downward rating pressure may emanate from a sustained deterioration in earnings, which may cause a material weakening in solvency. Furthermore, a significant deterioration in liquidity could also exert downward rating pressure.

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Related Criteria and Research

Criteria for the GCR Ratings Framework, May 2019
 Criteria for Rating Insurance Companies, May 2019
 GCR Ratings Scales, Symbols & Definitions, May 2019
 GCR Country Risk Scores, June 2019
 GCR South African Medical Schemes Sector Risk Score, September 2019

Ratings History

Rating class	Review	Rating scale	Rating class	Outlook/Watch	Date
Claims paying ability	Initial	National	BB _(ZA)	Stable	October 2001
	Last	National	AA _{-(ZA)}	Stable	May 2018

Risk Score Summary

Risk scores

Operating environment

Country risk score
Sector risk score

15.50

7.50
8.00

Business Profile

Membership profile
Management and governance

-1.25

-1.25
0.00

Financial profile

Earnings
Capitalisation
Liquidity

2.50

0.25
1.50
0.75

Comparative profile

Peer analysis

0.00

0.00

Total Score

16.75

Glossary

Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Beneficiary	Nominated person or institution in the policy document that is entitled to receive the proceeds stated in the policy.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capacity	The largest amount of insurance available from a company. In a broader sense, it can refer to the largest amount of insurance available in the marketplace.
Cash	Funds that can be readily spent or used to meet current obligations.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
Contract	An agreement by which an insurer agrees, for a consideration, to provide benefits, reimburse losses or provide services for an insured. A 'policy' is the written statement of the terms of the contract.
Coverage	The scope of the protection provided under a contract of insurance.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Experience	A term used to describe the relationship, usually expressed as a percent or ratio, of premiums to claims for a plan, coverage, or benefits for a stated time period.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For an insurer, its exposure may also relate to the risk related to policies issued.
Liquidity	The speed at which assets can be converted to cash. The ability of an insurer to convert its assets into cash to pay claims if necessary. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially
Rating Horizon	The rating outlook period
Rating Outlook	A rating outlook indicates the potential direction of a rated entity's rating over the medium term, typically one to two years. An outlook may be defined as: 'Stable' (nothing to suggest that the rating will change), 'Positive' (the rating symbol may be raised),
Reserve	(1) An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders. (2) An amount allocated for a special purpose. Note that a reserve is usually a liability and not an extra fund. On occasion a reserve may be an asset, such
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Solvency	With regard to insurers, having sufficient assets (capital, surplus, reserves) and being able to satisfy financial requirements (investments, annual reports, examinations) to be eligible to transact insurance business and meet liabilities.
Statutory Solvency Margin	Gives an indication as to whether the minimum regulatory solvency margin is being met, based on the net statutory assets to statutory net premiums ratio.

SALIENT POINTS OF ACCORDED RATING

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the rating was based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit rating has been disclosed to Fedhealth Medical Scheme. The rating above was solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the rating.

Fedhealth Medical Scheme participated in the rating process via face-to-face management meetings, and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from Fedhealth Medical Scheme and other reliable third parties to accord the credit ratings included:

- The audited financial results to 31 Dec 2018
- Four years of comparative audited numbers
- Unaudited interim results up to 30 April 2019
- Budgeted financial statements for 2019
- Other related documents.

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