



Credit Rating Announcement

GCR affirms Fedhealth's national scale financial strength rating of AA-(ZA) post amalgamation with Topmed; Outlook Stable

Rating action

Johannesburg, 30 October 2020 – GCR Ratings ("GCR") has affirmed Fedhealth Medical Scheme's ("Fedhealth") national scale financial strength rating of AA-(ZA), with a Stable Outlook.

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

Rating rationale

The rating affirmation reflects the scheme's sound capitalisation and liquidity, despite increased earnings pressure. This follows the amalgamation with Topmed Medical Scheme ("Topmed"), which had very strong solvency and a high claiming book. In GCR's view, reserve levels transferred to the scheme are more than enough to absorb increases in near term earnings risks. The business profile remained intermediate, with the amalgamation presenting offsetting changes on membership profile.

Capitalisation strengthened with the transfer of Topmed's relatively high reserve levels to the scheme, underpinning a 31% growth of the scheme accumulated funds to R1.5bn at FY19. The combined reserves were above requirements to cater for the concurrent increase in aggregate risks within the structure, which enhanced Fedhealth's GCR capital adequacy ratio ("CAR") and statutory solvency to 2.1x and 43% at FY19 (FY18: 1.8x and 31%), respectively. The strengthening in capitalisation may support a higher factor assessment, if earnings risk is well managed. As such, the scheme's ability to stabilise capitalisation at improved levels represents a key rating consideration over the medium term.

Liquidity also improved, with the investment portfolio increasing by 28% to R1.7bn at FY19, following the transfer of Topmed's portfolio to the scheme. Consequently, gross cash and stressed financial assets coverage of claims equated to a higher 4.7 months (FY18: 4.1 months), while operational cash coverage registered at a stable 0.9x. Nevertheless, possible elevation in claims payments over the medium term may result in liquidity metrics reverting to previous levels, given management's plans to maintain a relatively similar asset allocation post amalgamation. Therefore, the scheme's ability to maintain gross cash and stressed financial assets coverage of claims within a rating adequate range would be a key rating input over the medium term.

Earnings weakened materially in FY19 driven by a spike in claims, negating efforts to maintain a relatively stable cost structure and a 57% growth in investment income. As a result, net healthcare losses and net losses reached review period lows of R225m and R85m in FY19 (FY18: R84m loss and R31m; FY17: R28m and R104m), respectively. Going forward, claims pressures are likely to persist, despite implemented claims management measures. This, coupled with potential reductions in investment income and the membership base, among other earnings risks arising from the COVID-19 pandemic, could suppress earnings capacity below the current range.

The membership profile was negatively impacted by the aging of the membership base, after on-boarding Topmed's relatively older members. In this respect, the beneficiary age averaged a higher 43 years in FY19 (FY18: 39 years), while pensioner ratio almost doubled to 29% (FY18: 15%). Furthermore, Fedhealth's share of the open industry membership

base remained relatively stable around 3%, with lower than expected numbers from Topmed's former members joining the scheme, due to Fedhealth's different strategy and processes. As a result, more of Topmed's former members could leave the scheme over the medium term, which coupled with membership growth challenges stemming from increasing economic strain due to the COVID-19 pandemic, may further restrain the membership profile within weak ranges.

Outlook statement

The Stable Outlook reflects expectations that the scheme's membership profile is not likely to improve, while capitalisation and liquidity will be maintained at strong levels over the medium term. Accumulated reserves are viewed to be sufficient to tolerate claims pressure, as well as potential earnings strain from COVID-19 pandemic risks, such as reductions in contributions and investment income.

Rating triggers

Upward rating movement is unlikely over the medium term, but demonstrated ability to sustain very strong capitalisation with a statutory solvency well above 40%, while gross cash and stressed financial assets coverage of claims remains above 4.3 months, could be positively viewed. On the contrary, downward rating action could follow material and/or sustained deterioration in earnings, resulting in solvency and/or liquidity moderation beyond expectations.

Analytical contacts

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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, May 2020
 GCR South African Medical Schemes Sector Risk Score, July 2020

Ratings history

Fedhealth Medical Scheme					
Rating class	Review	Rating scale	Rating	Outlook	Date
Claims paying ability	Initial	National	BB _(ZA)	Stable	October 2001
Financial strength	Last	National	AA _{-(ZA)}	Stable	September 2020

Risk score summary

Rating components & factors	Risk scores
Operating environment	14.75
Country risk score	7.00
Sector risk score	7.75
Business profile	(1.50)
Membership profile	(1.50)
Management and governance	0.00
Financial profile	2.25
Earnings	0.00
Capitalisation	1.50
Liquidity	0.75
Comparative profile	0.00
Peer analysis	0.00
Total score	15.50

Glossary

Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Release	An agreement between the creditor and debtor, in terms of which the creditor release the debtor from its obligations.
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 as a reserve for taxes not yet due.
Reserves	A portion of funds allocated for an eventuality.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Short Term	Current; ordinarily less than one year.
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.

SALIENT POINTS OF ACCORDED RATINGS

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 is based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such rating is an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit rating has been disclosed to the rated entity. The rating was solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the rating. The rated entity participated in the rating process via virtual 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 the entity and other reliable third parties to accord the credit rating included:

- The audited financial results to 31 December 2019
- Four years of comparative audited numbers
- Unaudited interim results up to 30 September 2020
- Budgeted financial statements for 2020
- Other related documents.

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