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Rating-Agentur Expert RA GmbH upgraded the reliability rating of Balcia Insurance SE from 'BB' (Sufficient level of reliability) to 'BB+' (Sufficient level of reliability) according to the international scale. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

INSURANCE SECTOR RISK ASSESSMENT:

The insurer's operations are concentrated as follows: 73,7% in Poland, 17,6% in France, 6,3% in Lithuania, 1,4% in Italy, 0,5% in Spain, 0,4% in Germany and 0,1% in Latvia. The Insurance Sector Risk (ISR) of Poland is adequate, of France is low, of Lithuania is moderate, of Italy is low, of Spain is low, of Germany is very low and of Latvia is adequate. Therefore the overall risk exposure to the insurance sector of Balcia Insurance SE is adequate.

MAJOR FACTORS THAT INFLUENCED THE RATING:

Positive factors:

- The macro profile of the company is considered to be positive as Balcia operates in countries with an acceptable weighted average ISR score. This shows manageable systemic risks as the economies of the main countries of operations have shown positive and solid figures. However, the non-life insurance market penetration and density indicators are considered acceptable, except for Lithuania where the insurance sector is lagging its peers in terms of depth and development;
- The loss ratios for the main types of insurance have improved substantially between 2016 and 2017. Property insurance loss ratio improved from 86% to 62% and CMTPL from 67% to 63%. Despite improving, the combined loss ratio for CMTPL remains above 100% at 103%, showing a negative technical result for this segment;
- Profitability indicators, after removing the effect from the sale of BTA, were positive in 2017. ROA still presented a slightly positive result as it stood at 0,9% and ROE was 2,95%[1]. Even though the net income was negatively affected by the new tax legislation in Latvia, it remained barely positive at EUR 0,1 m in 2017;
- GWPs continue to grow consistently as they increased by 34,7% in 2017 led by a solid hike of around 55% y-o-y in the CMTPL insurance segment in Poland;
- There is a number of financial risk management procedures in place with clear quantitative tests such as sensitivity analyses and defined coverage ratios;
- The customer base remains diversified, as the top-10 clients account for only 8% of the total GWPs. Besides, these customers are slightly diversified by regions (France and Lithuania) and by types of insurance (Property and CMTPL);

[1] ROA and ROE are calculated as the profit **before tax** dived by the average of end-of-quarter assets and equity for the past two years respectively.

- The highest net paid claim by the company increased to 3,85% of equity as claim payments for the specific insured event continued in 2017 (initiated in 2015). However, we still consider the net paid claim to be low due to a significant amount of reinsurance participation (78% of the total claim value) signaling a good reinsurance policy. Additionally, the 10 highest current risk exposures are all reinsured;
- Good quality of reinsurers as 99% of the reinsurance partners have credit ratings higher than 'A-' in international scale. Furthermore, 99% of the potential claim payments for the 10 largest risks are also reinsured by companies rated above 'A-' in international scale. However, concentration has increased as 56,8% of the reinsurer's share in GWP is concentrated in one company (Vienna Insurance Group AG Wiener Versicherung Gruppe, rated 'A+' by S&P);
- Despite slightly increasing, the level of accounts payable and receivable to total assets remains adequate (10,9% and 8,3% respectively in 2017) indicating low indebtedness and reduced credit risk;
- The company's solvency capital requirement slightly deteriorated in 2017 but remained over the minimum Solvency II requirement in 2017 (2Q: 132%, 3Q: 127%, and 4Q: 128%);
- Strong and sustainable investment portfolio. As of end-2017 we calculate that around 88% of the investment portfolio was highly liquid, over 90% of investments were rated above investment grade and the concentration was acceptable as the share of largest investment was 36,5% in Polish sovereign bonds (rated 'A-' by Fitch, 'BBB+' by S&P and 'A2' by Moody's).

Restricting factors:

- Despite a steep increase in claims in 3Q 2017 and 4Q 2017, the company posted a positive technical result in 2017 after reporting consistently negative results in previous years. This was driven by an overall decline in claims as well as higher earned;
- The total net loss ratio stood at 75,1% in 2016 and has since improved to 62% in 2017, while the expense ratio went from 40,4% to 37,6%, which resulted in a combined loss ratio 99,6% in 2017. The above shows an important and consistent improvement of the technical result;
- The strategy of the insurer remains positive as it has achieved short-term goals outlined in 2016. We continue to assess this as solid as it continues to show clear objectives for each of the countries where it operates. Furthermore, we consider its projections in line with the stance of the markets and the systemic factors which prevail in the relevant countries. The company maintains a strategy which takes into account underwriting growth, cost optimization focus and conservative investment approach (e.g. focus in local currency-denominated government bonds). Nevertheless, premium growth expectations for 2017 in markets outside Poland and Lithuania fell short of the anticipated forecast figures. We still consider a challenging effort to penetrate these markets given the lack of a positive track record of market position and brand awareness as well as the competitive structure of the targeted markets which, we expect, will exert pressure on product pricing;
- Even though geographical diversification increased with the introduction of CMTPL products in Lithuania, we still consider regional diversification as limited since concentration increased in Poland. The operations of Balcia measured as a percentage of total GWP by end-2017 were mostly concentrated in Poland (73,7%), France (17,6%) and

Lithuania (6,3%). The rest of the operations were allocated in Italy (1,4%), Spain (0,5%), Germany (0,4%) and Latvia (0,1%);

- The company relies heavily on partners and brokers to sell its products. Balcia continues to develop new relationships with partners; currently the main partnership is with RESO Europa Service in Poland with whom a long-standing relationship exists. Estimated underwriting expenses as a percentage of earned premiums also improved in 2017 as they declined by around 3p.p. to stand at 39,5%. In line with this, client acquisition costs to earned premiums also declined substantially in 2017 when they stood at 26,7%, 6p.p. less than in 2016, while the average in Poland was 30% in 2016, unchanged from a year before. These figures show improvement in the cost management structure;
- Liquidity metrics have slightly deteriorated mainly due to the disappearance of the one-off effect which resulted from the sale of the Latvian subsidiary. However, they remain bearable as the ratio of liquid assets to total liabilities stood barely below 100% at 94%, the ratio of cash to net reserves stood at 57% as of end-2017 and net reserves were also well covered by liquid assets by 1,3x.

Negative factors:

- The market position of Balcia, despite slightly improving, remains moderately weak. The size of the company – as measured by gross written premiums (GWP) at EUR 97 m in 2017 – is still small taking into account the non-life insurance markets where it writes premiums. The company operates in seven different European markets; four of them being in the top-5 of total GWPs in Europe. Nonetheless, the company's activities continue to be focused in Poland (74% of total GWP) where it has slightly gained market share, especially in the Compulsory Motor Third Party Liability Insurance (CMTPL) segment. In this country, the company's GWPs accounted for 0,85% of the total GWPs and for around 2,9% of the CMTPL segment in 2017. However, the Polish market is characterized by high concentration (around 84% of GWP are accumulated in the top-10 insurance companies). The share in France has been reduced but the company penetrated the Lithuanian market with a solid share of 2,8% in CMTPL, which is positive for the market position given the company's experience in the Baltic region. In addition, the market stance decreased in the countries where Balcia has lower shares of written premiums, such as France, Germany, Italy, Latvia and Spain;
- The insurance portfolio concentration in the main insurance segment remains high and increased slightly from a year ago. CMTPL insurance amounted to 75% of Balcia's GWPs (9,2p.p. higher than in 2016) followed by 15% of property insurance in 2017;
- The return on investments (ROI) was low in 2017 at 0,83% of total investment assets. This, coupled with moderate ROI volatility, represents a risk for the income sustainability of the company.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Substantial increase in geographic and product diversification alongside a stable consolidation of the market position in one or several of the markets where the company operates.

The following developments could lead to a downgrade:

- Continued increase in incurred claims and operating expenses which would turn the technical in a downward trend;
- Constant deterioration of the main liquidity and solvency metrics.

JUSTIFICATION OF THE RATING:

The Agency upgraded the reliability rating of Balcia Insurance SE from 'BB' to 'BB+' with a stable outlook. The upgrade is mainly supported by the improved macro profile as reflected by the positive ISR score, improved underwriting and net profit results, a congruent and well defined strategy with realistic goals and projections as well as a risk averse investment strategy which includes high quality products and counterparties. The assessment is still supported by a satisfactory reinsurance policy, strong liquidity and solvency metrics and favorable risk management practices. On the other hand, the rating remains subdued by weak, albeit improving, market position in the markets where the company operates, low investment result and the increasing concentration of the market portfolio.

Balcia writes premiums in markets with low systematic risks. Poland, the main market for Balcia, has a strong and growing economy with acceptable insurance market depth and development. On the other hand, even though Lithuania also has a stable economic situation, the penetration and density in the region are quite low. The rest of the countries where the insurer is active have a positive environment for insurance companies to operate. In general, the weighted average ISR is favorable which means stability and moderate systematic risk for business. Nevertheless, the market position of the company remains quite weak as the market share, despite modestly increasing, remains quite low in Poland and France. However, the incursion in the Lithuanian market with an initial share above 2% in the CMTPL segment is a good sign of the potential of the insurer in the country. Moreover, Balcia is a well-known player in the Baltic region which could facilitate the introduction to the Lithuanian market. We still see the weak market position as one of the main risks for the company as the Polish market remains highly concentrated in a few companies. As a result, achieving high margins in the highly competitive CMTPL segment will continue to be challenging, especially since 75% of Balcia's portfolio is concentrated in this insurance product.

Balcia has been consistently expanding in Poland where GWPs have risen by 46% in 2017. However, it has lost market share and shrinking premiums in the rest of the countries as compared to 2016. The underwriting results have seen positive figures in 2017 as a result of higher earned premiums and slightly declining claims as expected in our previous review. As a consequence, combined ratios have also improved. The combined loss ratio of its main insurance segment, CMTPL, has also improved from 2016 but it remains slightly above 100%.

The strategy of the company remains acceptable. In our view, the expectations and projections set by the insurer are realizable and manageable under the current macroeconomic stance and the maturity of the insurance markets where Balcia operates. We still believe that the adequate risk management procedures in place, the positive structure of the customer base, the very good quality of the reinsurance policy and acceptable liquidity metrics, can support a favourable realization of the proposed strategy. However, we still see a considerable challenge the penetration of the developed markets as the company has no proven track record since the Balcia brand is fairly new and still getting to be known among current and potential stakeholders. However, we consider the access to the Lithuanian market as a positive step since the company has vast experience operating in the Baltic region slightly increasing the market position assessment.

We anticipate the investment result to continue to be subdued given the risk-averse strategy and the low-yield environment in Europe. Despite the low returns, the investment position of the company improved as compared to end-2016. Currently, 98% of deposits are in investment-grade-rated banks. Furthermore, the investment allocation continues to be conservative with high quality and liquid assets.

Additionally, the regulatory assessment, mainly based on Balcia's regulatory capital metrics, continues to influence the rating positively. The company's Own Risk and Solvency Assessment (ORSA) Report shows the capital coverage will be sufficient in the mid-term perspective.

The stable outlook is supported by our view that the main rating drivers will remain unchanged in the mid-term perspective.

COMPANY PROFILE:

Balcia Insurance SE is an insurance company based in Latvia which is currently focused on non-life insurance products, mainly CMTPL and Property Insurance. The main operations, measured by GWP, are in Poland, France and Lithuania with a smaller amount of operations in Italy, Spain, Germany and Latvia. The GWP of the company as of end-2017 amounted to EUR 97 m, its assets were equal to EUR 194 m and equity was EUR 55 m.

Responsible expert: Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH

Reviewer: Gustavo Angel, Rating Associate of Rating-Agentur Expert RA GmbH

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RATING HISTORY:

Date	Review reason	Rating Score	Outlook
15.05.2017	Initial assignment	BB	Stable

Minute's summary:

The rating committee for Balcia Insurance SE was held on 9 May 2018. The quorum for the rating committee was present. After the responsible expert presented the factors which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Insurance methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the rating class voting.

The rating was disclosed to the rated entity prior to the publication and was not changed during the process of coordination.

The following methodologies were used for the rating assessment:

- Methodology for Assigning Reliability Ratings to Insurance Companies – Full Version (from February 2018)
- Methodology for Assigning Insurance Sector Risk Score – Full Version (from February 2018)

Descriptions and definitions of all rating categories can be found under the following link: http://www.raexpert.eu/insurance/ under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

This rating is solicited. The rated entity participated in the rating assignment process.

No other third party participated in the preparation of the rating.

Main sources of information:

- Questionnaire from Balcia Insurance SE based on the form provided by the Agency
- IFRS Quarterly reports for 2016 and 2017
- Audited IFRS Annual reports for 2014, 2015, 2016 and 2017
- Balcia Insurance SE Own Risk And Solvency Assessment Report (Year 2016)
- Answer for additional request based on the form provided by the Agency
- Information from media and other public sources.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information as well as non-public information (obtained from the rated entity and/or other third parties) which was considered to be reliable, complete and non-biased. The responsible expert performed rating assessment of the insurance company with information considered as the most reliable and up to date in accordance to the overall position of the insurance company and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. The experts involved in the rating assessment and revision of the rated entity showed no conflict of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies from RAEX group.

Risk warning

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.