Rating-Agentur Expert RA confirmed the reliability rating of Balcia Insurance SE at 'BB+' according to the international scale. The rating outlook is stable.

Rating-Agentur Expert RA confirmed the reliability rating of Balcia Insurance SE at '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: 63,9% in Poland, 15% in France, 14,5% in Lithuania, 5,7% in Germany, 0,8% in Italy, 0,1% in Latvia and 0,03% in Spain. The Insurance Sector Risk (ISR) of Poland is adequate, of France is low, of Lithuania is moderate, of Germany is very low, of Italy is low, of Latvia is adequate, and of Spain is low. 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 has improved slightly and remains positive as the insurer operates in countries with an adequate level of our weighted average Insurance Sector Risk (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;
- The net loss ratios for the Compulsory Motor Third Party Liability Insurance (CMTPL) segment declined from 63% down to 61%, while CASCO insurance went from 56,6% to 47,8%. Both segments also show a combined ratio below 100%. Despite this, the property insurance segment's loss ratio hiked substantially from 46,6% in 2017 up to 102,5% in 2018 for a combined ratio of 140%;
- GWPs grew by 8% in 2018, a substantial decline as compared to the 34,7% hike in 2017;
- The risk management system is considered to remain adequate to the needs of the insurer. 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 concentrated slightly in the top-10 clients as these account now for 20% of total GWPs. However, previously, a high share of the main clients were in the property insurance segment, currently, all of the clients are in the CMPTL segment which carries lower concentration risk as one single contract has many underlying potential insured events. All of the top-10 clients are from Lithuania;
- The highest net paid claim by the company increased to 4,2% of equity as claim payments for the specific insured event continued in 2018 (initiated in 2015). However, we still consider the net paid claim to be low due to a significant amount of reinsurance participation (73% of the total claim value). Additionally, the 10 highest current risk exposures are all reinsured;

- The quality of reinsurers remains favorable as 98% of the reinsurance partners have credit ratings higher than ‘A-’ in international scale. However, concentration in Vienna Insurance Group AG Wiener Versicherung Gruppe (rated ‘A+’ by S&P) has increased even further as 70% of total GWPs are assigned to this company;
- The level of accounts payable and receivable to total assets declined slightly and remains adequate (10,1% and 5,2% respectively in 2018) indicating low indebtedness and reduced credit risk;
- The company's solvency capital requirement continued in a downward trend in 2018 and it now stands at 117% due to the decline in retained earnings resulting from the steep loss in 2018. Despite remaining above the minimum Solvency II requirement, its declining path and narrow margin reduces the room to implement a more aggressive insurance and investment policy;
- The investment portfolio remains solid and stable. Around 87% of the portfolio was liquid while around 88% of the assets are rated at investment grade. Moreover, concentration was acceptable as the share of the largest investment was 43,3% in Polish sovereign bonds (rated ‘A-’ by Fitch, ‘A-’ by S&P and ‘A2’ by Moody’s).

Restricting factors:

- We continue to consider the strategic approach as moderately positive. The insurer’s goals set out in 2017 were in line with developments seen in 2018, such as developing sales channels in Germany as well as diversifying the insurance portfolio in France and Poland, among others. Even though financial figures related to the technical result were not as anticipated as net claims were substantially higher than expected, we continue to see prudent expectations in the forecasts provided by the insurer as the company has a detailed and reasonable budget plan for 2019. The strategy and goals for the next year take into account political and economic situations in the countries where the company operates. Future growth of GWPs and clients is expected from more profitable insurance segments. Balcia also continues to implement a strategy which takes into account underwriting growth, cost optimization focus and conservative investment approach. However, the market position in Poland declined slightly as GWPs decreased by around 6% due to a decline in CMTPL pricing confirming our previous concern of the challenge it represents to operate in such a competitive segment. Due to continued competitiveness, increase in claims and payment strain from workshops and compensation companies, we expect the CMTPL segment to remain under pressure in Poland;
- Geographical diversification increased further in 2018. The operations of the company are concentrated in Poland (63,9%), France (15%), Lithuania (14,5%) and Germany (5,7%). From these countries, Lithuania and Germany saw the highest increase in share while the shares in Poland and France decreased. The rest of the operations were allocated in Italy (0,8%), Latvia (0,08%) and Spain (0,03%);
- The company still depends on partners and brokers to a great extend in order to sell its products as 96% of GWPs are generated through this channel. Balcia’s main partner is RESO Europa Service in Poland with whom a long-standing relationship exists and the insurer has also developed sales partnerships in Germany and France. Moreover, client acquisition costs to earned premiums remained quite stable at 23%, while the average ratio for non-life insurers in Poland was 22,2% in 2018. Also, Balcia’s underwriting expenses to earned premiums decreased by 2p.p. down to 37,9% as of the same date. These figures show efficient cost management;

- Liquidity deteriorated further in 2018 as a result of the steep increase in claims reserves; despite the decline, the ratios remain moderate. By the end of 2018, the ratio of liquid assets to total liabilities posted a figure of 88%, the ratio of cash to net reserves stood at 36%, while the net reserves remained covered by liquid assets by 1,15x. We anticipate liquidity metrics to improve going forward as reserves decrease;
- Profitability metrics took a big hit in 2018 also negatively affected the substantial increase in net incurred claims: ROA stood at -2,1% while ROE was -8,1%[1]. However, we expect the metrics to show a recovery in 2019 and 2020 as the effect of the property claims in France fades out.

Negative factors:

- The market position of the company remains moderately weak. The size of the company – as measured by gross written premiums (GWP) at EUR 105 m in 2018 – is still small taking into account the non-life insurance markets where it writes premiums. The company continues to operate in seven different European markets; four of them being in the top-5 of total GWPs in Europe. Nonetheless, the company's operations continue to be focused in Poland (64% of total GWP) where its highest market share is in the CMPTL segment. In this country, the company’s GWPs accounted for 0,7% of the total GWPs in the Polish non-life sector, a slight decline as compared to 2017, and the share in the CMTPL market shrunk slightly to stand just below 2% as of 2018. The Polish market remains highly concentrated as around 86,5% of GWPs were accumulated in the top-10 insurance companies by the end of 2018. The share of business in France has been reduced further and it is now about 15% of total GWPs and its share in the French market remains negligible. However, operations in the Lithuanian market continued to increase and Balcia now has a share of 4,6% in CMTPL segment, which is positive for the market position given the company’s experience in the Baltic region. In addition, the insurer also substantially increased its amount of premiums written in Germany by more than 3x, but market share is still very low. The market stance decreased in the rest of the countries (Italy, Latvia and Spain);
- The insurance portfolio is still concentrated on the CMTPL segment as its share on total GWPs remained practically unchanged from a year ago at 76%. However, there was a reshuffling of other segments as Property insurance accounted for 11% as compared to 15% in 2017 and the CASCO segment increased from 4,1% in 2017 up to 7,5% in 2018;
- Return on investment remains subdued as a result of the low interest rate environment in Europe combined with the conservative investment approach from the insurer. However, the ROI increased in 2018 up to 1,43% as the company looked to redistribute investment in more profitable assets (e.g. reduction in cash and increase in bonds as well as issued loans). Moreover, almost 50% of the return is derived from unrealized gains from asset revaluation;
- The technical result turned to negative territory in 2018 as a result of a steep hike on claim technical reserves due an increase in claims in the property insurance sector for municipalities in France. As a consequence, net incurred claims climbed by 24,6% y-o-y while net earned premiums did so by 10% y-o-y in 2018. We expect these metrics to reverse as the company has substantially reduced its exposure to property insurance for

[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.

French municipalities and it is planning to completely phase-out from this segment by year-end 2019;

- Given the aforementioned facts, the combined loss ratio has been above 100% along 2018. As of the end of 2018, the net loss ratio increased up to 70,2% from 62% in 2017, while the expense ratio declined down to 35,7% from 37,6% a year ago. This clearly shows that expense management has been successful and, at the same time, technical losses have been mostly driven by rising incurred claims.

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 result in a downward trend even when removing the effect of the phase-out of loss-generating insurance segments;
- Continued deterioration of the main liquidity and solvency metrics.

JUSTIFICATION OF THE RATING:

The Agency confirmed the reliability rating of Balcia Insurance SE at ‘BB+’ with a stable outlook. The confirmation is mainly supported by the improved macro profile as reflected by a slightly enhanced weighted average of the ISR score, consistency with the business plan and the company’s direction as well as our expectation that, despite a slump in underwriting and net profit, the insurer will continue to perform positively going forward as it has taken steps to avoid business segments which have been loss-generating. However, the Agency will monitor these developments closely in order to confirm its expectations. Moreover, our evaluation still considers a favorable reinsurance and risk management practices. Liquidity and solvency metrics, despite remaining acceptable, showed a slight deterioration in 2018. The reliability rating remains constrained by the weak market position in most markets, expect for Lithuania where market share in the CMTPL segment has increased, low investment results as well as low profitability and elevated concentration of the insurance portfolio.

The countries where Balcia mainly operates are considered to have low systematic risk according to our ISR score assessments. The insurance market in Poland is moderately well developed with an insurance penetration and density of USD 1,8 Non-life Premiums to GDP and USD 270 Non-life Premiums per capita respectively. Moreover, the country’s economy is growing and developing faster than its peers. In the case of Lithuania, penetration and density posted similar, albeit slightly lower, figures than Poland standing at USD 1,3 Non-life Premiums to GDP and USD 246 Non-life Premiums per capita respectively; additionally, Lithuania has a solid economy but highly exposed to external factors. The remaining countries are considered to have a very favorable environment for insures with strong financial systems and developed economies. In addition, we consider that all of the countries have above average institutional development as well as regulatory effectiveness.

The market position of Balcia is assessed as weak as it has a low market share in most of the countries where it writes premiums. The better market position is in Lithuania where the insurer accounts for about 4,6% of the CMPTL premiums and for 2,4% of the overall non-life market. In this country we have seen a rapid increase in market share, which is a positive indicator for the insurer's opportunities ahead. In Poland, it only has a 0,7% overall share of the non-life sector and slightly less than 2% of the CMPTL segment. In this country, the non-life sector grew at 7% y-o-y in 2018 while Balcia's GWPs in the country shrunk by 6% due to pricing reasons. Moreover, in Lithuania, the same sector grew at 12% while Balcia increased its GWPs by 150%. However, in the rest of the five countries, the market share is negligible. Furthermore, we still consider that it will remain a challenge to produce some positive yield in the CMTPL segment in Poland as we have already observed product pricing reductions in 2018 and competition and market concentration remain high.

The GWPs of the company increased by 8,3% in 2018, a slower pace as compared to 2017, while net incurred claims climbed by 24,6% mainly as a result of a substantial hike in claim reserve build-up due to claims in the municipal property segment in France as well as long-term reserve accumulation for CMTPL in Poland due to new regulatory directives. The above caused the underwriting result to be negative by year-end 2018 where the combined ratio stood at 106% with a net loss ratio of 70% and the expense ratio standing at 36%. However, we anticipate these metrics to improve as the insurer has reduced its exposure to the loss-generating municipal property segment in France and is in the process of exiting it completely by the end of 2019. Moreover, we expect CMPTL prices to increase in Poland as the insurers are now obliged to pay higher compensations[2]. Even though this will bring higher GWPs, it will also cause claims to rise. Even so, the combined ratio for the main type of insurance (CMTPL) remained slightly below 100% at 99,4% by the end of last year.

The reinsurance policy of the company remains positive. The insurer has exposure to 98% of reinsurers having financial strength rating from a recognized agency above the 'A-' level. Moreover, all of the highest risk exposures are reinsured.

The company's liquidity and solvency remain acceptable but deteriorated in 2018 while profitability turned negative. Liquidity metrics suffered from the steep increase in claim reserves while liquid assets only increased marginally. On the other hand, the solvency ratio was hurt due to the substantial net loss in 2018 which shrunk retained earnings and, thus, tier 1 capital levels. In addition, profitability figures turned to negative territory also suffering from the abrupt reserve build up and low investment income. Despite this, we anticipate all above metrics to improve going forward resulting from the improved insurance segment allocation.

The business plan and strategy of the company remain congruent and consistent. Goals continue to be set out in clear, concise and realistic manners and developments in 2018, despite some drawbacks, have behaved according to plans stated beforehand. The company has also presented the Agency with a realistic budget forecast for 2019 which takes into account insurance market as well as macroeconomic developments. Nevertheless, we still consider a challenge to penetrate new markets in such competitive product segments.

The investment result improved slightly and the company rebalanced its assets as it now holds more bonds and has issued around EUR 4 m of loans while at the same time, the company has reduced their cash holdings. The combination of the low interest rate environment alongside the conservative investment approach by the insurer will continue to result in low investment returns. However, the quality and liquidity of the portfolio are exceptional.

The current risk management system of the company is considered as positive. The Agency acknowledges that the current stance of the risk management system is adequate to the size of the company and the needs of the markets and insurance segments as well as investment

[2] A Supreme Court ruling in 2017 defined that insurers should pay compensations for permanent disability not only to the victim, but they should also pay to the victim's close relatives.

instruments used. The company’s Own Risk and Solvency Assessment (ORSA) Report continues to reflect that 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, CASCO 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-2018 amounted to EUR 105 m, its assets were equal to EUR 204 m and equity was EUR 50 m.

Related research:

- Research Report on the Insurance Industry of Central and Eastern Europe – 07.06.2018: https://raexpert.eu/files/Industry_report_Insurance_CEE_07.06.2018.pdf

For further information contact:

Responsible expert:
Hector Alvarez, Associate Director of Rating-Agentur Expert RA
+49 (69) 3085-45-00, ext.1213
alvarez@raexpert.eu

Reviewer:
Olena Kolokolova, Rating Analyst of Rating-Agentur Expert RA
+49 (69) 3085-45-00, ext.1216
kolokolova@raexpert.eu

Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

RATING HISTORY:

Date	Review reason	Rating Score	Outlook
15.05.2018	Scheduled review	BB+	Stable
15.05.2017	Initial assignment	BB	Stable

Minute's summary:

The rating committee for Balcia Insurance SE was held on 10 May 2019. 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 Rating scale section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

The definition of default can be found on the Agency's website in the section for Internal policies.

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, 2017 and 2018
- Audited IFRS Annual reports for 2014, 2015, 2016, 2017 and 2018
- Balcia Insurance SE Own Risk And Solvency Assessment Report (Year 2018)
- 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

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

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.