

RAM



SHIFT IN COMPETITIVE LANDSCAPE

INSURANCE SECTOR REPORT 2009

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Summary

The Sri Lankan insurance sector is a crucial component for economic development. Nonetheless, it only accounts for a small segment of the domestic financial landscape. The sector's potential is underscored by its low penetration rate; this segment only represented 1.32% of the country's GDP and 3.2% of the system's financial assets as at end-December 2008. Insurance is vital for economic development, providing a cushion against calamities faced by enterprises and individuals.

The concept of insurance had originated in the colonial era, with a view to providing coverage for the booming plantation sector. In 1961, the government nationalised this industry, at which point there were more than 60 local and foreign insurance companies and agencies. After more than 2 decades of state monopoly, the industry was liberalised in 1986, soon after which 3 local players had established themselves. At present, there are 19 players in the insurance sector; of these, 2 concentrate solely on the life business while 5 focus on only the general sector.

With an increasing number of players and the removal of fixed tariffs, market competition has heightened, especially in the general segment. On the other hand, price-based competition is easing, with more emphasis on product innovation and service quality. Not surprisingly, overheads eat into the profitability of the general segment. Some industry players focused on increasing reach by opening branches, however, corresponding premium growth was not achieved. As a result overheads were further pushed up. Profitability is, instead, driven by investment income. Prospectively, companies will focus on redefining their business models to maintain performance in light of the increased competition and receding interest rates. Improving operational efficiencies will be a key factor, together with rationalising of product portfolios to more appropriately reflect risks underwritten.

Going forward, macroeconomic fundamentals must improve before the industry can reach its full potential. The growth prospects afforded by such a change would also ease competitive pressures and facilitate risk-based premiums. Increased penetration, together with prudent underwriting standards, will enable the industry to amass diversity in its portfolio, thus augmenting its risk-absorption capacity. At the same time, the industry must place greater emphasis on risk management and balance sheet strength. However, the lack of qualified personnel is a major hindrance that could limit the industry's growth.



Background

The insurance industry had germinated in Sri Lanka during the colonial era, to support the booming coffee and tea trades. The primary participants in the insurance business then had been the agency houses that managed the plantations and acted as agents of overseas insurers, chiefly handling their in-house plantation businesses. In the early 20th century, life-insurance companies were established.

The first Sri Lankan insurance company - Ceylon Insurance Company Ltd – was only established after the passing of the Companies Act of 1938; this was later followed by several others. The local insurance industry came to the fore after the enactment of the Motor Traffic Act in 1951, which made third-party insurance coverage compulsory.

In 1961, the government nationalised the industry, following which Sri Lanka Insurance Company ("SLIC") had been set up as the sole insurance provider. At that time, there had been more than 60 local and foreign insurance companies and agency houses. In a bid to encourage competition, the state created the National Insurance Cooperation in 1980. Continuing on this path the state permitted private entities to join the fray in 1986. Soon afterwards, 3 insurance companies had started operations, i.e. Ceylinco Insurance PLC ("Ceylinco"), Eagle Insurance PLC ("Eagle") and Union Assurance PLC ("UAL"). In 2002, foreign equity participation in insurance companies was allowed.

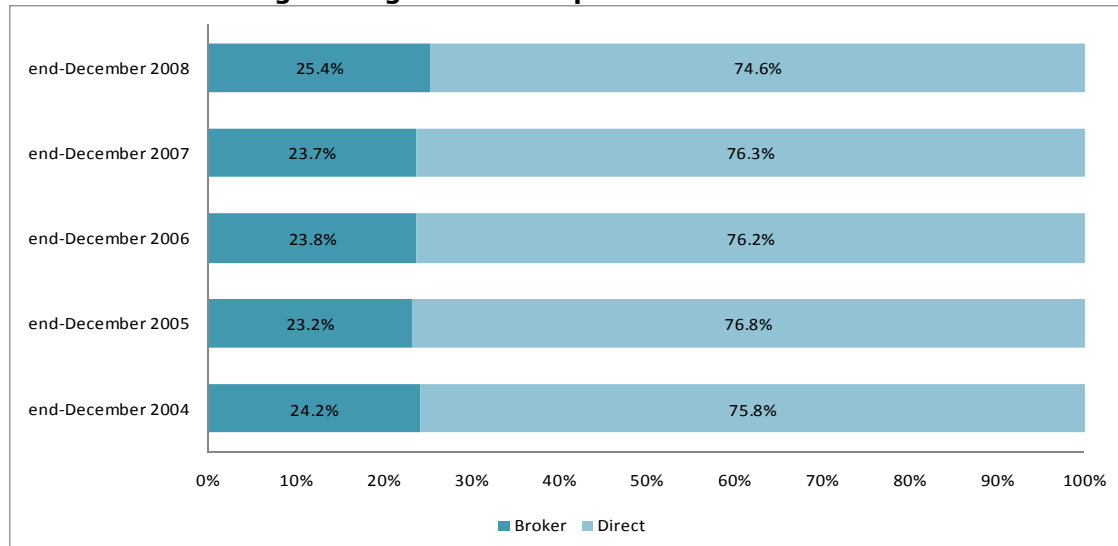
Today, there are 19 players in the Sri Lankan insurance industry; of these, 12 are engaged in both the general (or "non-life") and life (or "long-term") businesses, 2 solely underwrite life insurance and 5 are involved only in the general business. We note that companies which carry out both life and general businesses, are legally a single entity, but operate as two different units. The insurance industry is also supported by a network of insurance brokers that account for a significant portion of business in the general segment. As at end-December 2008, 25.40% of the sector's general gross written premiums were derived from broker channels (refer to Chart 1); this is in line with historical levels. However, contributions to the life segment have been negligible (end-December 2008: 0.76%).

Table 1: Insurance companies and their business lines

	General	Life
Allianz Insurance Lanka Ltd	✓	
Allianz Life Insurance Lanka Ltd		✓
Amana Takaful Ltd	✓	✓
Asian Alliance Insurance Co Ltd	✓	✓
Ceylinco Insurance PLC	✓	✓
Ceylinco Takaful Ltd*	✓	
Chartis Insurance Ltd	✓	✓
Continental Insurance Lanka Ltd	✓	
Co-operative Insurance Co Ltd	✓	✓
Eagle Insurance Co Ltd	✓	✓
HNB Assurance Ltd	✓	✓
Janashakthi Insurance PLC	✓	✓
Life Insurance Corporation (Lanka) Ltd		✓
MBSL Insurance Co Ltd	✓	✓
National Insurance Trust Fund	✓	
Peoples Insurance Ltd	✓	
Seemasahithia Sanasa Rakshana Samagama	✓	✓
Sri Lanka Insurance Coporation	✓	✓
Union Assurance PLC	✓	✓

* Licence has been suspended

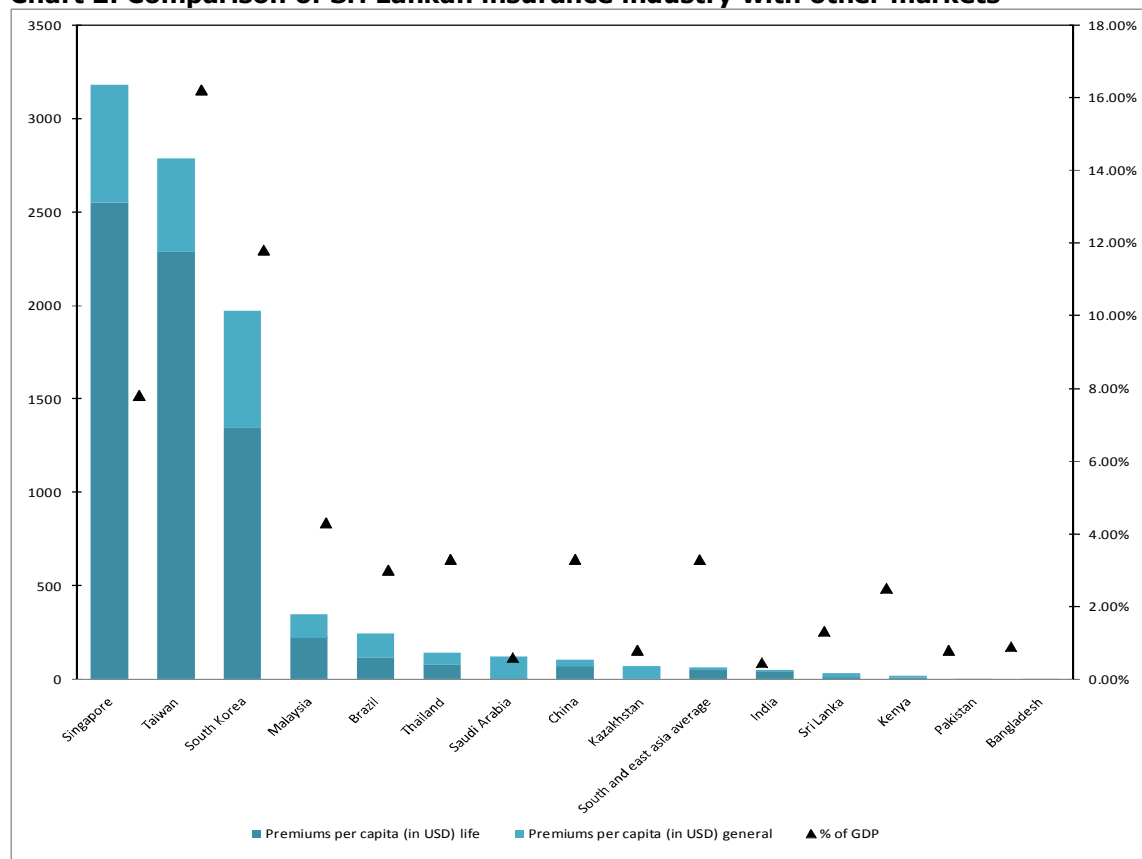
Chart 1: Sources of general gross written premiums



Source: IBSL annual report, 2008

The insurance sector accounted for 3.2% of Sri Lanka’s financial assets as at end-December 2008, and contributed 1.32% to the nation’s GDP. In comparison to other countries, the Sri Lankan insurance sector still has enormous growth potential (refer to Chart 2).

Chart 2: Comparison of Sri Lankan insurance industry with other markets



Source: Swiss Re

Regulations

The domestic insurance industry comes under the purview of the Insurance Board of Sri Lanka ("IBSL"). The IBSL was created in 2001, through the implementation of the Regulation of Insurance Industry Act No. 43 of 2000. Prior to that, the industry had been regulated by the Controller of Insurance of the Ministry of Finance, through the Control of Insurance Act No. 25 of 1962.

The IBSL closely monitors each insurance company, requiring them to provide certain information on a quarterly basis. Such information includes company accounts, detailed breakdowns of their investments, segmentation of premiums, outstanding re-insurance and debtors'-ageing analysis. One of the key measures of an insurance company's financial stability is its solvency margin; in simple terms, this is the excess amount of assets an insurance company maintains over its liabilities. Going forward, the IBSL intends to implement risk-based capital assessment, which is similar to the Central Bank's measurement of financial institutions' capital adequacy.

Of late, the IBSL has been quick to take action against both insurance companies and brokers that have breached regulations. RAM Ratings Lanka views that such

actions will lead to better compliance throughout the industry, thus increasing protection for policy holders.

Besides the IBSL, special insurance bodies have also been formed, such as the following:

- The Sri Lanka Export Credit Insurance Corporation ("SLECIC") provides various export credit solutions to exporters and guarantees to banks and financial institutes on behalf of exporters. The SLECIC had been created to develop the local export market, focusing on small and medium-sized exporters.
- The Agricultural and Agrarian Insurance Board ("AAIB") was established in 1999, to provide insurance coverage to the broad agricultural sector. The AAIB offers comprehensive insurance schemes and social-security schemes for the agricultural, farming and fishing communities.
- The National Insurance Trust Fund ("NITF") had been set up because the incumbent president had felt the need for an insurance company dedicated to public-sector employees, and a conduit to implement government policies. The NITF recently also become a reinsurer; local players must cede at least 20% of reinsurance premiums to it.
- The Strike, Riot, Civil Commotion & Terrorism Fund ("SRCC & T") was created in 1987, with the main objective of providing reinsurance support in respect of strikes, riots, civil commotion and terrorism activities within the geographical limits of Sri Lanka. This followed the 1983 riots, which had caused vast losses and resulted in reinsurers denying reinsurance support to these particular classes of business. The SRCC & T had been absorbed into the NITF upon its creation.

Meanwhile, the IBSL maintains a policy holders' protection fund. This fund is credited with inflows from a cess of 0.2% on the net written premiums for the life business and 0.4% of the net written premiums for the general business. As at end-December 2008, the fund contained LKR 545.35 million (end-December 2007: LKR 384.42 million). This is to be used for the general protection of policy holders and for any other purpose determined by the IBSL.

Going forward, the IBSL has proposed changes to the calculation of the solvency margin, widening the range of acceptable investments and refining the definition of investments. We view this in a positive light as it enhances risk management for an investment portfolio. Furthermore, the IBSL is in the process of implementing a regulatory framework for the micro-insurance sector, which has been attracting the interest of many insurers.



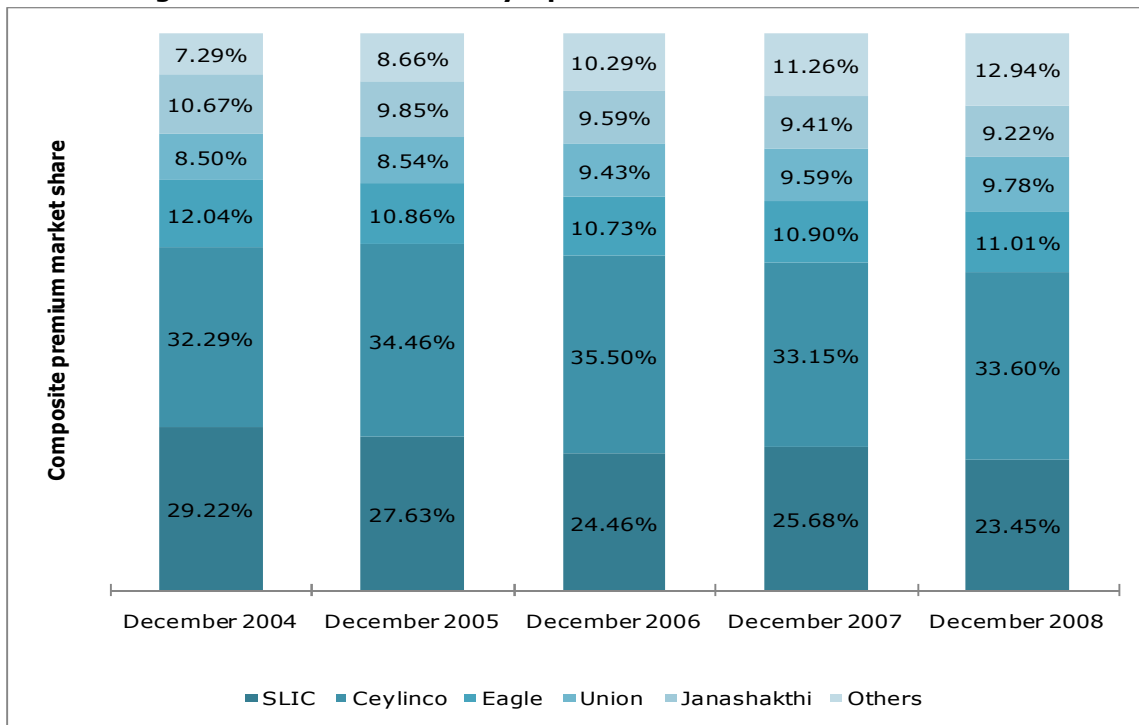
Competitive Position

The insurance sector in Sri Lanka is highly competitive. The industry had experienced fierce price undercutting following the removal of tariffs from the motor (in 2002), fire (in 2005), and workmen's compensation (in 2007) sub-classes. Insurance players with more extensive geographical reach are able to maintain a more stable financial performance, as their risks are spread across a larger retail segment. In terms of business underwritten, the smaller players are dwarfed by the larger, more established ones that boast broader distribution channels.

Meanwhile, the industry is highly concentrated as the pioneers dominate the playing field. SLIC, as the longest-surviving insurer in operation, overshadowed its peers by taking up 42.05% of the industry's asset base as at end-December 2008. Not surprisingly, the next largest player was a distant second (24.53%) as at the same date. In terms of business underwritten, however, the second-largest player surpassed the biggest. These top 2 companies accounted for 57.05% of the industry's composite premiums as at end-December 2008 (refer to Chart 3); the top 5 made up 87.06% as at the same date.

To compete, several smaller players have adopted a "niche market" strategy; while some focus on providing insurance to the grassroots, others target the upper echelons of society. All in all, the smaller players have been eroding the market shares of the top 5 – a trend that is expected to continue. Besides size and reach, other factors such as service quality and product innovation are also key drivers of competitiveness. Going forward, the industry will focus on redefining their business models, in wake of heightening competition and receding investment income. Companies will have to take a closer look at internal processes, to take advantage of synergies and optimize operational efficiency.

Chart 3: Segmentation of the industry's premiums



Source: IBSL annual report 2008

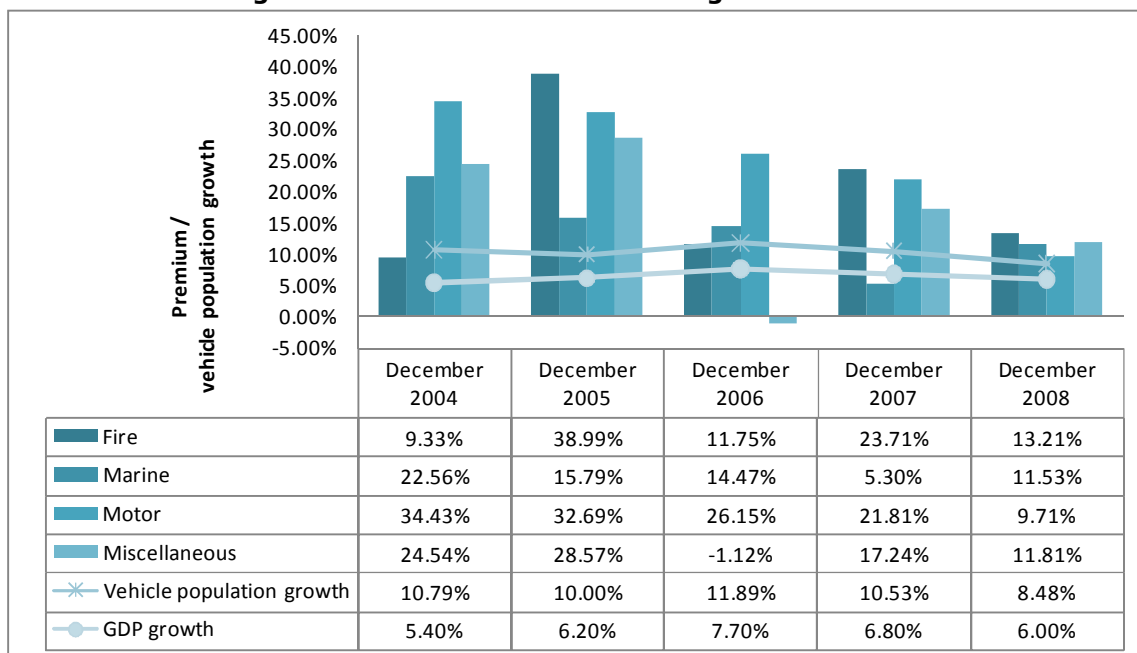
The sector has grown significantly in the last few years; the number of branches spiked up from 374 as at end-December 2004 to 921 as at end-December 2008, in line with the overall industry's expansion. However, we note that branch network is still concentrated in the western province - the economic hub of the nation. Furthermore, the rapid increase in the number of branches has strained companies' financial performance; heftier overheads have not been matched by corresponding levels of premium income.

The industry experienced rapid growth over the last few years; premiums doubled from LKR 25.55 billion as at end-December 2003 to LKR 58.17 billion as at end-December 2008. Nonetheless, we note that premium growth decelerated in 2008, albeit still achieving a double-digit growth, amid the bleak economic climate. The industry's premium growth slowed to 12.10% in 2008, from 20.57% the previous year.

The industry's premiums can be segmented into either the general or life sector. As at end-December 2008, about 59.40% of total industry premiums originated from general insurance while life accounted for 40.60%. General premiums were dominated by the motor sub-class, as the law dictates that every vehicle must have at least third-party insurance coverage. Premiums from the motor sub-class constituted 54.17% of the industry's general premiums. The growth momentum of this key segment skidded to 9.71% in 2008, from 21.81% the previous year (refer to Chart 4) - in line with decelerating vehicle growth. Premium expansion in the life segment had also been adversely affected by rising inflation; the growth of this sector receded to 13.91% in 2008 (2007: 21.91%).



Chart 4: Premium growth vs total vehicles and GDP growth



Source: IBSL annual report 2008, Department of Motor Traffic, Central Bank of Sri Lanka annual report 2008

In the face of stiff price competition, insurance players have focused on innovation and service standards to maintain an edge. On this note, local companies have won several international accolades for their endeavours. The motor sub-class has been the catalyst for product development; examples include on-site claims assessments and dedicated vehicle garages.

Some insurance players have also shown interest in alternate insurance models, such as bancassurance and micro insurance. A few companies have tied up with banks to provide bancassurance services, although this is still in the nascent stage; this form of business only takes up a small portion of the industry's total underwritten premiums. Meanwhile, micro insurance has also attracted some of the larger players; presently, 2 companies focus solely on this segment.

Underwriting Quality & Risk Exposure

Effective underwriting standards are vital for the long-term success of an insurance company, as its premiums must be able to cover any claims made. Inappropriately priced policies will lead to losses in the core business, and undermine the company's ability to meet its policy holders' claims. A key indicator of a company's underwriting expertise is its claims ratio. When examining the claims ratio, it is useful to delve into the claims from each segment, as the associated risks would be different. The industry is classified into 4 broad categories: motor, fire (includes all natural disasters), marine, and miscellaneous (includes health and other types).

The motor segment dominates industry's general premiums, accounting for 54.17% of gross written premiums as at end-December 2008 (refer to Table 2); the miscellaneous (21.79%), fire (18.75%) and marine (5.28%) segments accounted for the rest. In terms of earned premiums, however, motor insurance made up 71.81% of total premiums earned while contributions from the fire sub-class were much less (3.82%). This was due to the varying degrees of reinsurance support for each class. Earned premiums are arrived at after deducting premiums paid to the reinsurer; this is the premium that is actually retained by the insurance company.

Table 2: Breakdown of gross written premiums and earned premiums for each segment

	end-December 2005		end-December 2006		end-December 2007		end-December 2008	
	Gross	Earned	Gross	Earned	Gross	Earned	Gross	Earned
Fire	18.48%	7.36%	17.84%	4.47%	18.37%	4.77%	18.75%	3.82%
Marine	6.06%	3.89%	6.00%	3.94%	5.25%	3.01%	5.28%	3.19%
Motor	49.54%	65.15%	54.01%	70.41%	54.76%	71.93%	54.17%	71.81%
Miscellaneous	25.92%	23.60%	22.15%	21.17%	21.61%	20.29%	21.79%	21.18%

Source: IBSL annual report 2008

Reinsurance support for the motor segment is low due to the relatively smaller exposures. A good measure of reinsurance support is the retention ratio, which reflects the percentage of premiums retained from the gross premiums written. The retention rate for the motor sub-class is the highest (end-December 2008: 95.03%) while that for the fire sub-segment is the lowest (end-December 2008: 12.64%) (refer to Table 3). The difference in retention levels reflects the nature of the risks in each class; the sum insured in the motor sub-class is relatively low compared to that for fire. Although the probability of a claim is also lower for fire insurance, it can have an adverse impact on the company due to its size. As such, reinsurance provides a cushion in case of a calamity. In simple terms, reinsurance allows an insurance company to mitigate its risk, as it can share the underwriting risk with another party. Reinsurance contracts can be broadly classified into the following:

- Proportional: under this type of reinsurance, the insurance company will cede a specific share of risk accepted by the company. The reinsurer will receive a certain percentage of the premium, and will in turn pay a certain percentage of the claim.
- Non-proportional: as the name suggests, the reinsurer will pay claims based on certain limits that are specified according to the particular contracts.

Table 3: Retention rates for each class of insurance

	end-December 2003	end-December 2004	end-December 2005	end-December 2006	end-December 2007	end-December 2008
Fire	17.57%	18.57%	21.24%	15.61%	24.06%	12.64%
Marine	42.09%	43.19%	51.67%	41.14%	39.73%	36.13%
Motor	95.63%	95.92%	95.14%	95.55%	94.61%	95.03%
Miscellaneous	51.57%	71.64%	74.44%	71.37%	70.46%	67.62%

Source: IBSL annual report 2008

Despite the fierce price competition within the industry, claims have been relatively stable. Claims in the motor segment have been moderate, averaging around 63% over the past 5 years (refer to Table 4); the European Union's average clocks in at around 75% while India's stands at 92%¹. Going forward, we do not expect the recent state ruling - of making police reports mandatory for every accident - to have a material impact on the motor sub-segment's claims ratio.

Meanwhile, the marine insurance segment's claims experience has been lower than other categories, backed by better tracking and monitoring of international cargo. Claims within the fire sub-class, meanwhile, has varied over the past 5 years, from a high of 123.93% as at end-December 2004 following the tsunami disaster to a low of 47.05% as at end-December 2005 (end-December 2008: 73.20%). Elsewhere, the lofty claims ratio for the miscellaneous segment is attributable to the medical sub-class, which generally experiences hefty claims. We note that insurers underwrite these contracts to retain clients, who may be profitable in other classes; there is also no reinsurance support for these contracts.

Table 4: Claims ratio for each segment

	end-December 2003	end-December 2004	end-December 2005	end-December 2006	end-December 2007	end-December 2008
Fire	47.69%	123.93%	47.05%	68.81%	84.79%	73.20%
Marine	28.91%	31.72%	22.37%	30.34%	35.56%	28.39%
Motor	62.42%	63.89%	63.48%	60.44%	65.15%	64.07%
Miscellaneous	75.75%	83.54%	70.52%	65.20%	63.94%	71.85%

Source: IBSL annual report 2008

Investment Portfolio

The keen price competition in the general segment is supported by high investment returns. With interest rates falling, however, companies will be challenged to maintain their margins.

Although investments are an integral part of insurance companies, investment management remains fairly rudimentary. As investment income bolsters financial performance, decisions have been based more on the yields of the investment portfolio rather than the risks it entails. As such, we observe that many players in the industry do not have fine-tuned investment policies.

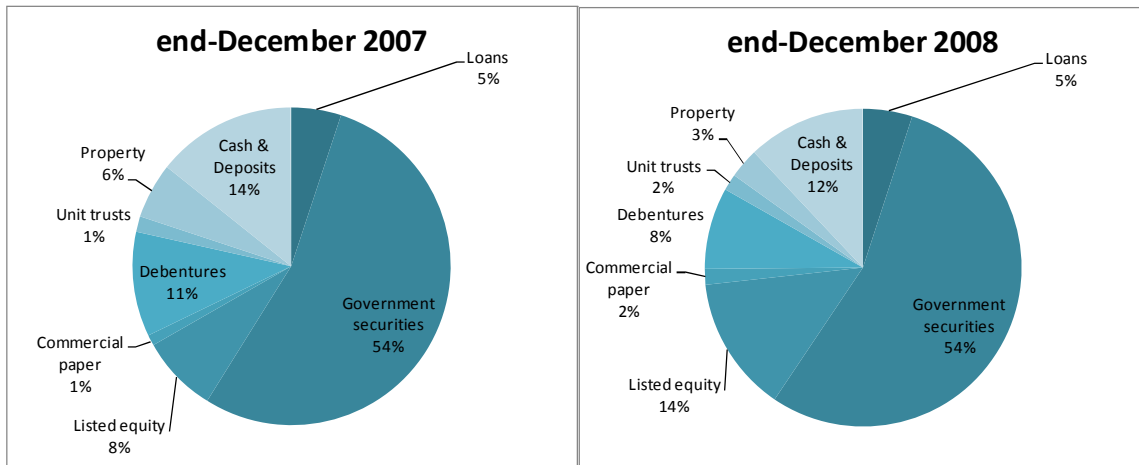
When looking at the overall industry, most of the investments have been parked in risk-free government securities, which at that time had offered high returns. This type of investment made up 54% of the industry's total investments while listed equity (14%), cash and deposits (12%), and debentures (8%) comprised the other notable investment avenues (refer to Chart 5). We note that regulation requires

¹ Mainly due to deregulation in 2007; competitors had slashed rates to gain market share. However, this has led to even worse claims ratios, as the premiums charged did not reflect the risks underwritten. While claims remained relatively stable, premiums shrank, thus augmenting the claims ratio.

insurance companies to maintain a minimum of 20% and 30% of their general and life investments, respectively, in government securities. However, the sector's contribution to the government debt market is relatively low. Shares held by insurers accounted for only 3% of the market's overall capitalisation as at end-December 2008. In contrast, the European average comes up to around 22%; nonetheless, we observe that European markets' average fluctuates between 1% and 55%.

RAM Ratings Lanka opines that the lack of suitable financial assets is a constraint against diversity in the industry's investment portfolio. In this regard, insurance companies also lack variety in their long-term investments vis-à-vis matching the long-term liabilities arising from life policies. Life funds are presently invested in short-term investments, thus returns on these funds are linked to volatile interest rate fluctuations. The industry requires long-term investment avenues to better plan proceeds to life policyholders. In this regard, a more active corporate debt market would be a positive.

Chart 5: Insurance industry's composite investment portfolio



Source: IBSL annual report

With the bulk of their investments in government securities, insurance companies enjoy healthy growth in their investment income, in line with rising interest rates. As interest rates retreat, however, income from these sources is expected to wane while exposure to treasury assets recedes. In the short term, companies will make gains on their equity portfolios as the bourse surges to unprecedented levels. Over the longer term, however, insurance companies will have to focus on improving the profitability of their core businesses and take a more active approach to managing their investment portfolios; at present, they depend on investment income to offset the losses from their general businesses.

Capitalisation & Reserving

The IBSL requires all insurance companies to increase the paid-up capital for each line of business to LKR 500 million by end-December 2010; companies had been required to meet the earlier benchmark of LKR 250 million by end-December 2008. Furthermore, insurance companies must maintain solvency margins of greater than 1 time for each class of business.

The solvency margin is the difference between the values of the assets and liabilities required to be maintained by the insurer. In the general class, an insurer has to maintain a margin greater than the highest of the following:

- LKR 50 million.
- A sum equivalent to 20% of the net premium.
- A sum equivalent to 40% of the average net outstanding for the preceding 3 years.

For the life section, the margin must be greater than 5% of policy liabilities. A higher solvency margin is viewed positively, as it provides a company with a greater buffer during times of stress.

Table 5: Solvency margins of top industry players

	2007		2008	
	General	Life	General	Life
Ceylinco	1.26	3.88	1.41	5.19
Eagle	4.06	1.20	3.19	1.32
Janashakthi	1.04	2.01	1.13	6.5
UAL	1.36	1.09	1.46	1.06

Source: Company annual reports

In terms of reserving, it is a regulatory requirement for all insurance companies to have life reserves valued by a qualified actuary. However, actuarial valuation of the general reserves is optional; we note that 4 of the 5 largest players have actuarially valued general reserves, as do many smaller players. A simple tool used to assess the reserving of a company is its reserve-adequacy ratio; this is the company's earned premiums as a percentage of technical reserves. As per international standards, this ratio should be greater than 150%; however, we note that this norm takes into account long-term liabilities such as asbestos, which the local market does not cater to; our norm is 100%. Apart from SLIC, whose reserves have been built up over time, none of the other top 5 players' ratios meets our benchmark.

RAM Ratings Lanka acknowledges that the adequacy and appropriateness of reserve levels cannot be ascertained without proper knowledge of each insurer's business. A low level of reserves, especially for outstanding claims, may reflect short delays in settling claims or may be caused by inadequate reserving in the face of protracted disputes. Similarly, a high level of reserves may reflect conservative reserving in the face of such delays, or it may be caused by excessive reserving in a bid to

understate profits and reduce tax liability.

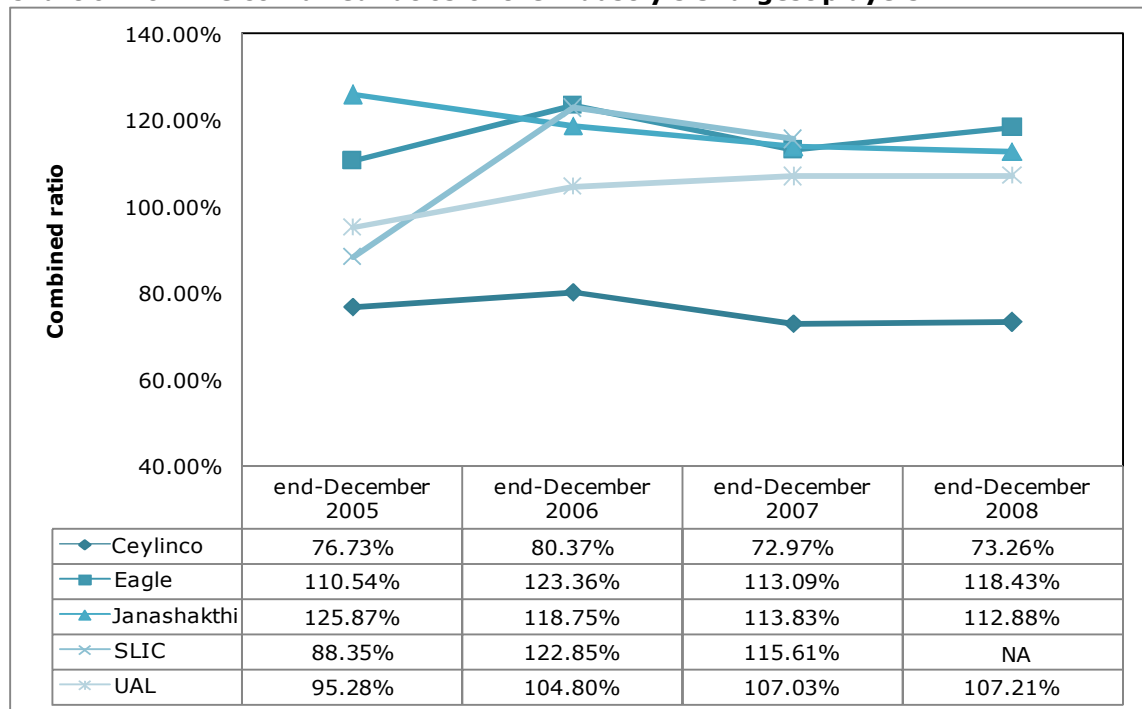
Reinsurance

Besides the regulation that requires 20% of reinsurance premiums to be directed to NITF, all reinsurers must also carry investment-grade ratings from a recognised credit-rating agency. Apart from reinsurance support, reinsurers also assist local companies to improve their underwriting standards. On a more positive note, with the end of the 3-decade-long civil war, we expect reinsurance premiums to decline in the marine segment, as reinsurers have attached an additional war-risk premium to this sector.

Profitability

As mentioned earlier, core non-life businesses run at a loss, with income mainly supplemented by investments and the life section. The combined ratio measures the core profitability of an insurance company; it is the result of adding a company's claims ratio with its expense ratio. A combined ratio of less than 100% indicates an underwriting profit; anything above would represent a loss. Combined ratios in the non-life business of the top players stood above 100% as at end-December 2008 (refer to Chart 6). Going forward, insurance companies will have to focus on controlling overheads and better pricing of their products to improve their core profitability.

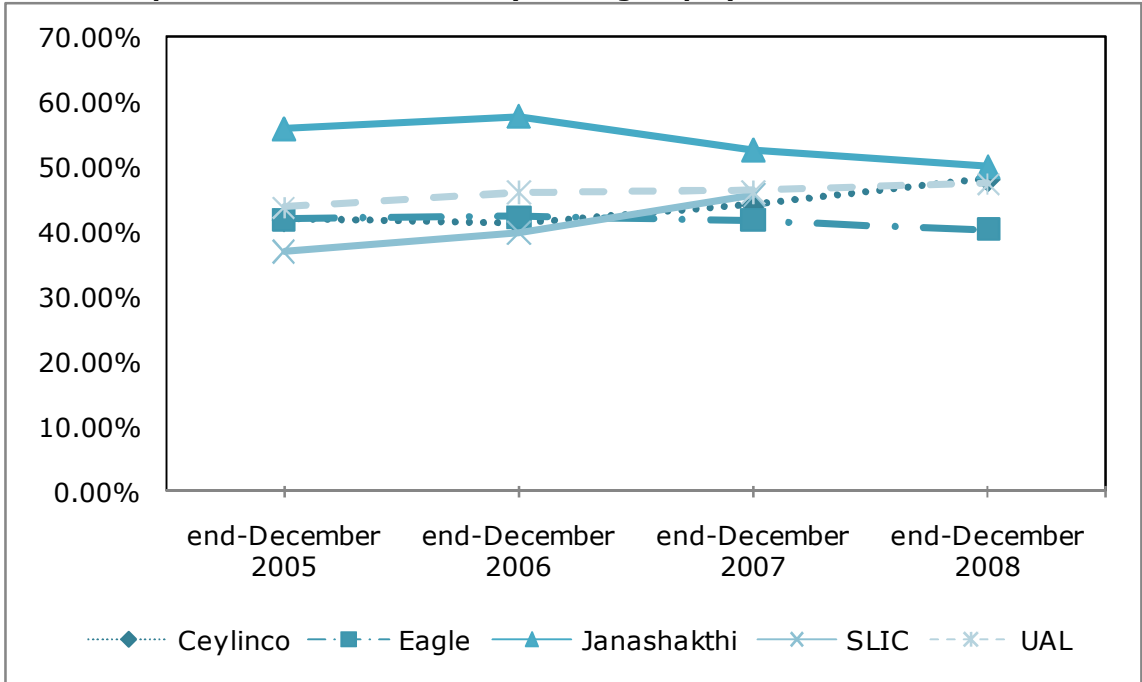
Chart 6: Non-life combined ratios of the industry's 5 largest players



Source: Company annual reports

Hefty overheads have weighed down the financial performance of the industry. The expense ratios of various players have been fluctuating between 45% and 55% (refer to Chart 7); the international average comes up to around 30%. The insurance industry relies on economies of scale; this is evident from the smaller companies' relatively high expense ratios. Besides insurance firms' cost rationalisation, better use of IT systems and a more stable macroeconomic framework could also help ease expense ratios.

Chart 7: Expense ratios of the industry's 5 largest players



Source: Company annual reports

Corporate Governance

The future growth of the insurance industry depends on continued macroeconomic stability, sound regulation and avoidance of company failures as well as scandals that could undermine public confidence in this sector. Meanwhile, corporate governance has come to the fore of late; in this regard, we note that the insurance industry does not follow prescribed practices (unlike banks and registered finance companies, which adhere to the Directions issued by the Central Bank of Sri Lanka), but instead subscribe to the general directions on corporate governance issued by the local accounting body. At the same time, we also acknowledge the varying degrees of importance placed on corporate governance and risk management by the industry participants.

All said, corporate governance in the insurance sector is as crucial as in other financial institutions acting as custodians of public money. As such, proper checks and balances have to be maintained. Besides regulations, an appreciation for risk

management must also be fostered within the organisation, mainly emanating from the board.

Prospects

The insurance industry is poised for growth, in line with the improving macroeconomic recovery prospects. However, lack of awareness on insurance products remains a major stumbling block for expansion. Although we note the actions taken by the regulator and players to promote knowledge of insurance, more efforts must be made to increase penetration, especially with regard to life insurance.

With investment income expected to recede, the industry will also have to concentrate on improving underwriting results. In this regard, overheads will have to be clamped down.

The lack of qualified personnel, meanwhile, is another constraint on the industry's growth. Few insurance companies have qualified insurers at the helm; there is also a dearth in actuaries. We note that actuaries are vital in determining reserving requirements, product pricing and bonuses.

Going forward, the adoption of international financial reporting standards ("IFRS") / international accounting standards ("IAS") will be a key hurdle to manage for the entire industry. The transition will introduce several risks to industry players who do not have adequate resources and expertise to implement the changes.



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