20. Management of Insurance and Financial Risks

Governance Framework
The Association has established a risk management function with clear terms of reference and with the responsibility for developing policies on market, credit, liquidity, insurance and operational risk. It also supports the effective implementation of policies at the overall association and individual business unit levels.

The policies define the Association's identification of risk and its interpretation, limit structure to ensure the appropriate quality and diversification of assets, alignment of underwriting and reinsurance strategies to the corporate goals and specify reporting requirements.

Regulatory Framework
Regulators are interested in protecting the rights of the members and maintain close vigil to ensure that the Association is satisfactorily managing affairs for the member's benefit. At the same time, the regulators are also interested in ensuring that the Association maintains appropriate solvency position to meet liabilities arising from claims and that the risk levels are at acceptable levels.

The operations of the Association are subject to the regulatory requirements of the IC. Such regulations not only prescribe approval and monitoring of activities but also impose certain restrictive provisions (e.g., margin of solvency to minimize the risk of default and insolvency on the part of the insurance companies to meet the unforeseen liabilities as these arise, minimum guaranty fund, risk-based capital requirements).

Guaranty fund
As a mutual benefit association, the IC also requires the Association to possess a guaranty fund of ₱5.00 million. This minimum amount shall be maintained at all times and it must be increased by an amount equivalent to 5% of the Association's gross premium collections. As of December 31, 2015 and 2014, the Association has a total of ₱9.28 million and ₱8.03 million in 2015 and 2014, respectively, representing guaranty fund which is deposited with the IC. The guaranty fund is presented as "Appropriated fund balance" in the statements of financial position.

Risk-based capital requirements (RBC)
On December 8, 2006, the IC issued IMC NO. 11-2006 adopting the RBC framework for the mutual benefit associations to establish the required amounts of capital to be maintained by entities in relation to their investment and insurance risks. Every mutual benefit association is annually required to maintain a minimum RBC ratio of 100.00% and not fail the trend test. Failure to meet the minimum RBC ratio shall subject the insurance entity to the corresponding regulatory intervention which has been defined at various levels.

The RBC ratio shall be calculated as member's equity divided by the RBC requirement whereas; Members' equity is defined as admitted assets minus all liabilities inclusive of actuarial reserves and other policy obligations.

The following table shows how the RBC ratio was determined by the Association based on its calculation:

	2015	2014
Member's equity	**₱20,621,243**	₱15,559,149
RBC requirement	**1,096,512**	1,176,583
RBC Ratio	**1881%**	1322%

The final amount of the RBC ratio can be determined only after the accounts of the Association have been examined by the IC specifically as to admitted and non-admitted assets as defined under the same Code.

The main risks arising from the Association's financial instruments follow:

Insurance Risk

The principal risk the Association faces under insurance contracts is that the actual claims and benefit payments or the timing thereof, differ from expectations. This is influenced by the frequency of claims, severity of claims, actual benefits paid are greater than originally estimated and subsequent development of long term claims. Therefore, the objective of the Association is to ensure that sufficient reserves are available to cover these liabilities.

The above risk exposure is mitigated by diversification across a large portfolio of insurance contracts and geographical areas. The variability of risks is also improved by careful selection and implementation of underwriting strategy and guidelines.

Underwriting risk

Underwriting risk represents the exposure to loss resulting from actual policy experience adversely deviating from assumptions made in the product pricing. Underwriting risks are brought about by a combination of the following:

- *Mortality risk* - risk of loss arising due to policyholder death experience being different than expected.
- *Morbidity risk* - risk of loss arising due to policyholder health experience being different than expected.
- *Investment return risk* - risk of loss arising from actual returns being different than expected.
- *Expense risk* - risk of loss arising from expense experience being different than expected.
- *Policyholder decision risk* - risk of loss arising due to policyholder experiences (lapses and surrenders) being different than expected.

These risks do not vary significantly in relation to the location of the risk insured by the Association, type of risk insured and by industry. Undue concentration by amounts could have an impact on the severity of benefit payments on a portfolio basis.

The Association's underwriting strategy is designed to ensure that risks are well diversified in terms of type of risk and level of insured benefits. Underwriting limits are in place to enforce appropriate risk selection criteria. For example, the Association has the right not to renew individual policies, it can impose deductibles and it has the right to reject the payment of fraudulent claims. Insurance contracts also entitle the Association to pursue third parties for payment of some or all cost. The Association further enforces a policy of actively managing and prompt pursuing of claims, in order to reduce its exposure to unpredictable future developments that can negatively impact the Association.

The key assumptions to which the estimation of liabilities is particularly sensitive are as follows:

Mortality and morbidity rates

Assumptions are based on standard industry and national tables, according to the type of contract written, reflecting recent historical experience and which are adjusted where appropriate to reflect the Association's own experiences. An appropriate but not excessive prudent allowance is made for expected future improvements.

An increase in rates will lead to a larger number of claims and claims could occur sooner than anticipated, which will increase the expenditure and decrease the funds of the Association.

Investment return
The weighted average rate of return is derived based on a model portfolio that is assumed to back liabilities, consistent with the long term asset allocation strategy. These estimates are based on current market returns as well as expectations about future economic and financial developments. An increase in investment return would lead to a reduction in expenditure and an increase in the funds of the Association.

Expenses
Operating expenses assumptions reflect the projected costs of maintaining and servicing in force policies and associated overhead expenses. The current level of expenses is taken as an appropriate expense base, adjusted for expected expense inflation adjustments if appropriate. An increase in the level of expenses would result in an increase in expenditure thereby reducing the funds of the Association.

Lapse and surrender rates
Lapses relate to the termination of policies due to nonpayment of premiums. Surrenders relate to the voluntary termination of policies by policyholders. Policy termination assumptions are determined using statistical measures based on Association's experience and vary by product type, policy duration and sales trends.

An increase in lapse rates early in the life of the policy would tend to reduce the funds of the Association, but later increases are broadly neutral in effect.

Discount rate
Life insurance liabilities are determined as the sum of the discounted value of the expected benefits and future administration expenses directly related to the contract, less the discounted value of the expected theoretical premiums that would be required to meet these future cash outflows. Discount rates are based on current industry risk rates, adjusted for the Association's own risk exposure.

A decrease in the discount rate will increase the value of the liability.

<u>Sensitivities</u>
The analysis below is performed for a reasonable possible movement in key assumptions with all other assumptions held constant, on the statement of revenue and expenses. The correlation of assumptions will have a significant effect in determining the ultimate claims liabilities. It should also be stressed that these assumptions are nonlinear and larger or smaller impacts cannot easily be gleaned from these results. Sensitivity information will also vary according to the current economic assumptions, mainly due to the impact of changes to both the intrinsic cost and time value of options and guarantees.

2015

	Increase of 1.00% on discount rate and decrease of 25.00% on mortality rate	Decrease of 1.00% on discount rate and increase of 25.00% on mortality rate
Increase (decrease) on liabilities	**(₱6,934,905)**	**₱6,934,905**
Increase (decrease) on revenue	**6,934,905**	**(6,934,905)**

2014

	Increase of 1.00% on discount rate and decrease of 25.00% on mortality rate	Decrease of 1.00% on discount rate and increase of 25.00% on mortality rate
Increase (decrease) on liabilities	(₱5,662,942)	₱5,662,942
Increase (decrease) on revenue	5,662,942	(5,662,942)

The sensitivity analyses take into account upward movements in the discount rates and upward and downward movements in mortality and morbidity rates. These do not necessarily represent management's view of expected future rate changes.

Financial instruments
The Association's principal financial instruments are cash, short-term investments, loans and receivables, accrued expenses and other liabilities. The main purpose of these financial instruments is to finance their operations.

The following table sets forth the carrying values and estimated fair values of financial assets and liabilities recognized as of December 31, 2015 and 2014:

	2015		2014	
	Carrying Value	**Fair Value**	Carrying Value	Fair Value
Financial Assets				
Loans and receivables				
Cash	**₱17,822,497**	**₱17,822,497**	₱11,157,046	₱11,157,046
Short-term investments	**28,759,119**	**28,759,119**	24,355,550	24,355,550
Receivables				
Due from MFI branches	**5,027,800**	**5,027,800**	5,263,458	5,263,458
Interest receivable	**54,920**	**54,920**	80,813	80,813
Loans receivable	**200,000**	**200,000**	–	–
	₱51,864,336	**₱51,864,336**	₱40,856,867	₱40,856,867
Financial Liability				
Accrued expenses and other liabilities	**₱320,583**	**₱320,583**	₱519,182	₱519,182

Due to the short-term nature of transactions, the carrying amounts of financial instruments such as cash, short-term investments, loans and receivables, accrued expenses and other liabilities approximate their fair values.

Financial Risks

The Association is exposed to financial risk through its financial assets, financial liabilities and insurance liabilities. In particular, the key financial risk that the Association is exposed to is that the proceeds from its financial assets may not be sufficient to fund the obligations arising from its insurance contracts. The most important components of this financial risk are credit risk, liquidity risk and market risk.

These risks arise from open positions in interest rate, currency and debt securities products, all of which are exposed to general and specific market movements.

Credit risk

This is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

The following policies and procedures are in place to mitigate the Association's exposure to credit risk:

a. The credit risk in respect of customer balances, incurred on non-payment of premiums or contributions will only persist during the grace period specified in the policy document or when the policy is either paid up or terminated.

b. Reinsurance is placed with highly rated counterparties and concentration of risk is avoided by following policy guidelines in respect of counterparties' limits that are set each year and are subject to regular reviews. At each reporting date, management performs an assessment of creditworthiness of reinsurers and update the reinsurance purchase strategy, ascertaining suitable allowance for impairment.

c. The Association sets the maximum amounts and limits that may be advanced to corporate counterparties by reference to their long term credit ratings.

The table below shows the maximum exposure to credit risk for the components of the statements of financial position.

	2015	2014
Financial Assets		
Loans and receivables		
Cash (excluding cash on hand)	**₱17,812,497**	₱11,147,046
Short-term investments	**28,759,119**	24,355,550
Receivables		
Due from MFI branches	**5,027,800**	₱5,263,458
Loan receivable	**200,000**	–
Interest receivable	**54,920**	80,813
	₱51,854,336	₱40,846,867

The table below provides information regarding the credit risk exposure of the Association by classifying assets according to the Association's credit ratings of counterparties as of December 31, 2015 and 2014.

2015

	Neither Past-Due nor Impaired			
	Investment Grade	**Non-investment Grade**	**Past Due and Impaired**	**Total**
Financial Assets				
Loans and receivables				
Cash	**₱17,822,497**	**₱–**	**₱–**	**₱17,822,497**
Short-term investments	**28,759,119**	**–**	**–**	**28,759,119**
Receivables				
Due from MFI branches	**5,027,800**	**–**	**–**	**5,027,800**
Advances to MIMAP	**736,378**	**–**	**–**	**737,378**
Loan receivable	**200,000**	**–**	**–**	**200,000**
Interest receivable	**54,920**	**–**	**–**	**54,920**
Advances to officers and employees	**4,500**	**–**	**–**	**4,500**
	₱52,605,214	**₱–**	**₱–**	**₱52,605,214**

2014

	Neither Past-Due nor Impaired			
	Investment Grade	Non-investment Grade	Past Due and Impaired	Total
Financial Assets				
Loans and receivables				
Cash	₱11,157,046	₱–	₱–	₱11,157,046
Short-term investments	24,355,550	–	–	24,355,550
Receivables				
Due from MFI branches	5,263,458	–	–	5,263,458
Advances to MIMAP	700,000	–	–	700,000
Loan receivable	–	–	–	–
Interest receivable	80,813	–	–	80,813
Advances to officers and employees	60,000	–	–	60,000
	₱41,616,867	₱–	₱–	₱41,616,867

The Association uses a credit rating concept based on the borrowers and counterparties' overall credit worthiness, as follows:

Investment grade - Rating given to borrowers and counterparties who possess strong to very strong capacity to meet its obligations.

Non-investment grade - Rating given to borrowers and counterparties who possess above average capacity to meet its obligations.

The Association trades only with members who are also members of the related parties. The receivables represent mostly collections of the related parties pertaining to contributions for premiums for life insurance, loan redemption assistance and provident fund unremitted to the Association. Receivables are generally on a 1-30 days terms and are all current. All receivables are neither past due nor impaired.

The Association conducts periodic review of allowance for credit losses each financial year through examining the financial position of the related party and the market in which the related party operates.

Liquidity risk
This risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial instruments.

The following policies and procedures are in place to mitigate the Association's exposure to liquidity risk:

a) The Association's liquidity risk policy sets out the assessment and determination of what constitutes liquidity risk for the Association. Compliance with the policy is monitored and exposures and breaches are reported to the management. The policy is regularly reviewed for pertinence and for changes in the risk environment.

b) Set guidelines on asset allocations, portfolio limit structures and maturity profiles of assets, in order to ensure sufficient funding available to meet insurance and investment contracts obligations.

The following table shows an analysis of assets and liabilities analyzed according to whether they are expected to be recovered or settled within one (1) year and beyond one (1) year from reporting date:

2015

	Up to one year	**1-3 years**	**3-5 years**	**Over 5 years**	**No term**	**Total**
Financial assets						
Loans and receivables						
Cash	**₱17,822,497**	**₱–**	**₱–**	**₱–**	**₱–**	**₱17,822,497**
Short-term investments	**28,759,119**	**–**	**–**	**–**	**–**	**28,759,119**
Receivables						
Due from MFI branches	**5,027,800**	**–**	**–**	**–**	**–**	**5,027,800**
Advances to MIMAP	**736,378**	**–**	**–**	**–**	**–**	**736,378**
Loan receivable	**200,000**	**–**	**–**	**–**	**–**	**200,000**
Interest receivable	**54,920**	**–**	**–**	**–**	**–**	**54,920**
Advances to officers and Employees	**4,500**	**–**	**–**	**–**	**–**	**4,500**
	₱52,605,214	**₱–**	**₱–**	**₱–**	**₱–**	**₱52,605,214**
Financial liabilities						
Other financial liabilities						
Claims payable	**₱143,600**	**₱–**	**₱–**	**₱–**	**₱–**	**₱143,600**
Accrued expenses	**249,934**	**–**	**–**	**–**	**–**	**249,934**
	₱393,534	**₱–**	**₱–**	**₱–**	**₱–**	**₱393,534**

2014

	Up to one year	1-3 years	3-5 years	Over 5 years	No term	Total
Financial assets						
Loans and receivables						
Cash	₱11,157,046	₱–	₱–	₱–	₱–	₱11,157,046
Short-term investments	24,355,550	–	–	–	–	24,355,550
Receivables						
Due from MFI branches	5,263,458	–	–	–	–	5,263,458
Advances to MIMAP	700,000	–	–	–	–	700,000
Loan receivable	–	–	–	–	–	–
Interest receivable	80,813	–	–	–	–	80,813
Advances to officers and employees	60,000	–	–	–	–	60,000
	₱41,616,867	₱–	₱–	₱–	₱–	₱41,616,867
Financial liabilities						
Other financial liabilities						
Claims payable	₱346,100	₱–	₱–	₱–	₱–	₱346,100
Accrued expenses	423,500	–	–	–	–	423,500
	₱769,600	₱–	₱–	₱–	₱–	₱769,600