The Pakistan Credit Rating Agency Limited

General Insurance and *Takaful* Operator – Insurer Financial Strength (IFS) Rating Methodology

An opinion on the ability of the general insurer/ *takaful* operator to meet policy holder.

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1. INTRODUCTION

- Rating specific to policyholders obligations
- Rating scale same for general and general insurance

1.1 Insurer Financial Strength (IFS) rating of a non-general insurer assesses the financial strength of the company and its capacity to meet obligations to policyholders on a timely basis. The financial strength rating is assigned to the company itself, and no liabilities or obligations of the insurer are specifically rated unless otherwise stated. The financial strength rating does not address the willingness of management to honor company obligations, nor does the rating address the quality of a company's claims handling services. In the context of the financial strength rating, the timeliness of payments is considered relative to both contract and/or policy terms and also recognizes the possibility of acceptable delays caused by circumstances unique to the insurance industry, including claims reviews, fraud investigations and coverage disputes.

1.2 PACRA is alive to the distinction that general insurance carries with respect to its risks and challenges despite its generic commonality with life insurance business. PACRA recognizes the need to document its approach towards rating the general insurance companies and general *takaful* operators. This methodology draws upon the international perspective and the local experience gained through interaction with the market players and other participants of the broad financial sector of Pakistan. The basic objective of this methodology is to enhance transparency of PACRA's rating process by clearly specifying and discussing the relevant factors for the IFS rating of the insurers[1].

1.3 The general insurance rating assigned by PACRA is essentially an opinion of the rating agency on the ability of the respective company to repay policyholder liabilities. This rating is forward-looking in nature. This is so because the liabilities it covers belong necessarily to the future period. Therefore, it is utmost critical that the financial indicators which are depicting a certain risk profile of the insurer remain stable over the medium term. Consequently, the approach that PACRA has employed is a blend of qualitative and quantitative data. The quantification helps in achieving objectivity in the rating process while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither all factors can be quantified nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ a best combination of both and would stick to it to ensure comparability on historical as well as synchronic basis.

1.4 PACRA's analyses incorporate an evaluation of the rated company's current financial position as well as an assessment of how the financial position may change in the future. Our ratings methodology includes an assessment of both quantitative and qualitative factors based on in-depth discussions with senior management. The evaluation of financial strength and credit quality centres on the ability of the company to meet all of its obligation towards policy holders.

1.5 Although this methodology has distinct approach towards analysis and synthesis, the rating scale on which general insurers' ratings are placed are the same as that for life insurance companies. The reason is that, despite differences, the ultimate obligations being covered are towards the policyholders. This is why both should have same notational values besides same definitions. Likewise, PACRA believes that insofar as obligations towards policyholders are considered, there is no difference between general insurance companies and general *takaful* operators. The latter would be employing Islamic principles for the structure of the business; however the efficacy of these principles and the operators' adherence to them would remain the prerogative of the *shari'ah* advisors of the company. This entails that IFS rating assigned to the general *takaful* operator would not be an opinion on the accuracy of the principles and quality of operator's adherence to these principles.

[1] The term "Insurers" denotes both general insurer and general *takaful* operators wherever these are not separately mentioned.

2. BUSINESS RISK

- Focus on underwriting and investment operations
- Viability on a stand-alone basis

2.1 The objective of business risk analysis it to establish the company's ability to sustain – indeed – grow its relative positioning in the industry while ensuring profitable operations. PACRA has a structured approach towards evaluation of business risk, which integrates all the elements of the business starting from the premium ending with the profit/loss of the company. PACRA looks at both the underwriting profit/loss (core business performance) and overall profitability (impact of investment income and provisions etc).

Gross Premium + Claims & Acquisition = Underwriting Profit/loss

Underwriting Profit/Loss + Investment Income/Prov. = Profit/Loss (PBT/PAT)

2.2 Industry Dynamics: The process for IFS rating of the general insurers builds on PACRA's understanding of the general/*takaful* industry dynamics. This understanding, following an in-depth research approach, is documented. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In points of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to see whether the local players have established effective mitigants against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps PACRA to form a view on industry's significance in the economic environment of the country, its attractiveness to entrepreneurs, barriers to entry, and the power of suppliers and customers.

2.3 Market Position: Market position reflects the standing of the general insurer in the related market. The stronger this standing is, the stronger is the company's ability to sustain pressures on its business volumes and profit margins. This standing takes support from various factors including a) market size, b) growth trend, and c) franchise value/brand value.

2.3.1 Market Share: Market size represents the company's penetration in the chosen market. Size is advantageous as it provides ability to acquire larger business, pricing power and better expense management. There is a positive correlation between an insurer's absolute and relative size and its market position and brand value. The large companies exercise greater power over the pricing, while ensuring commensurate profits. Small companies struggle to obtain business; and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion which provides a clear yardstick to analyze the comparative strength of the market players. The more distant a player is from the average on the positive side, the stronger is its ability to reflect the characteristics just mentioned. In a dynamic industry, which is not characterized by concentration, PACRA believes that relative size would better capture the strength of the company's standing in the related market. Having said that, size for the sake of size is not worth it, if the insurer is unable to adhere to underwriting discipline and pricing superiority. The quality of risk management guidelines and their invariable implementation is the key to ensuring sustainability in the market position. Aggressive expansion at the expense of underwriting quality is considered negative.

2.3.2 Growth Trend: While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the insurer continues to have the ability to meet (or beat) the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This reflects in the ability of the players to invest in human resource, upgrade the control environment, enhance the product slate, increase the outreach, and improve the quality of service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.

- Industry
- Market Position
  - Market Share
  - Growth Trend
  - Brand
- Diversification
  - Premium
  - Client
  - Geographic
- Profitability
- Investments

2.3.3 Brand Value: An insurer's brand reflects the strength of its image and reputation in the market, recognition and perception of its products by the distributors and ultimate clients. The brand also commands the clients' loyalty, ability of the insurer to cross-sell, while bringing down its cost of distribution. Typically, higher and sustainable price trends would highlight the strength of the brand and/or franchise value. This would help the company to strengthen its market share, ensure comparative growth rate and enjoy healthy margins. While a stronger combination of these enable the insurer to withstand prolonged difficult market conditions, these also enable it to carve out new niches and tap emerging opportunities better than peers. Consequently, the strength of the competitive position would have a direct bearing on the rating of the insurer.

2.4 Diversification: Diversification is a holistic perspective. It encompasses many aspects which govern the business model of an insurer. Diversification is utmost desirable. The rationale for this is that diversification enhances the ability of the insurer to meet challenges, both present and upcoming. The lack of diversification gives rise to concentration risk, reflecting vulnerability of the insurer to few elements. Concentration is considered a major negative because it limits the insurer's ability to ensure sustainability in its business let alone expand it. At the same time, it enhances the risk of disruption in the operations if the area of concentration goes wrong. Based on this understanding, PACRA places high emphasis on diversification of premium across Fire, Marine, Motor and Misc. segments. Within Misc. segment, a balanced mix of all contributing elements would be appreciated. This does not entail that a company specializing in a certain product/segment would be put at a disadvantage. The disadvantage would only arise, if the company's business gives rise to concentration risk.

2.5 Profitability: The operations of a general insurer operator are a combination of two activities: underwriting and investments. Hence profitability of both segments need to be gauged.

2.5.1 Underwriting: The focus of PACRA's analysis of profitability is to understand the sources of profits, the level of profits on both and absolute and relative basis, and potential variability in profitability. Profits for non-life insurers are sourced from two primary functional areas 1) underwriting and 2) investment income. As indicated above, profits from underwriting are generated when operating revenues (generally premiums) exceed the sum of losses and cost of acquisition (including management and admin expenses). The underwriting margin, and its volatility, generally correlates with the level of risk that is being assumed. The profitability from underwriting is measured through combined ratio.

2.6 Investment Performance: Profits derived from investments can take the form of interest, dividends and capital gains. The level of investment earnings is dictated by the investment allocation strategy and the quality of management. Like underwriting income, investment returns and their volatility are also correlated with the level of risk assumed. PACRA measures overall profitability (underwriting and investing) by calculating the company's operating ratio. To further understand the quality of earnings, PACRA evaluates the diversification of earnings, as earnings that are well diversified tend to be less volatile.

3. FINANCIAL RISK

- Efficient claims repaying ability
- Strength of re-insurance
- Asset quality
- Liquidity coverage
- Capital adequacy

3.1 The underlying objective of financial risk analysis is to assess the general insurer's ability to meet its financial obligation particularly those towards the policy holders.

3.2 Claims Efficiency: The underlying risk that the insurer financial strength rating covers is the risk of claims not being met by the insurer. Timely and accurate repayment of claims carries utmost importance in the rating methodology. Claims efficiency represents the pattern in which claims are being settled by the general insurer operator. PACRA believes that insurers having higher rating would be carrying lower amount of outstanding claims in general circumstances (adjusted for one-off events). While this ensures ultimate satisfaction of the policy holder, it denotes spread-out of cash outflows over a number of period instead of their accumulation to a single year. This safeguards an insurer from building an undue pressure on the liquidity of the company in any specific period.

3.3 Re-insurance: The re-insurance is the risk coverage obtained by the insurer against insurance claims. Herein, business philosophy of the insurer with reference to risk retention comes into play. A high quantum of risk retention means higher exposure to claims though profits would be higher as well. PACRA looks at what kind of rating the re-insurer enjoys, their experience in the Pakistani market, their historical relationship with the insurer, treaty terms, and their respective share in the reinsurance pool.

3.4 Liquidity: The liquidity profile of the insurer is the ultimate cover that the company has against claims. The general insurer operator may carry multiple shields against the claims. The first shield being the operational cash flows coming in the form of premium and return on investments. An effective structure deployed in the operational framework would ensure that a significant portion of claims is being met through the operational cash flows. The second shield is the liquid investment book. The investment book may represent investment in a mix of fixed income and equity securities. Equity securities are adjusted for those scrips wherein volumes are insignificant. PACRA believes that the mix of the investment book is critical in assessing the overall comfort which may be placed on the liquidity of the company. While exposure towards the equity market may be determined by the investment philosophy of the company, PACRA relates the extent of exposure with the overall risk profile of the insurer and hence its IFS rating. The third shield of protection is the strategic investment book, if any. PACRA assesses the quality of the strategic book and its size in the light of the insurers' liquidity requirement and attractiveness of the book for disposal.

3.5 Asset Quality: The quality of the investment book is assessed to form an opinion that the investments are not concentrated in high risk avenues. Apart from the equity investments, which are otherwise viewed in the context of the overall risk appetite of the insurer, the remaining investments are evaluated from the perspective of the credit profile of the investee.

3.6 Capital Adequacy: At the heart of PACRA's financial risk assessment lies the adequacy of the capital for the insurer's business. Capital is pivotal for organizational sustainability, growth drive and as a last cushion against adverse circumstances. PACRA evaluates the capital in the context of the company's business model. This understanding stems from the realization that a company following a high risk and high growth business strategy would need entirely different capital requirement as against a company following a conservative business model. While computing and analyzing the capital, PACRA considers the regulatory regime applicable to the general insurer/general *takaful* operators, and their internal models, if any, for judging the adequacy of capital.

3.6.1 For a viable business, PACRA understands that the capital has to be serviced as well. Therefore, analysis of the return on capital and its consistency is another importance aspect of capital adequacy assessment. While a company is generating returns, it may have a varied policy with reference to the payout to the shareholders. PACRA believes that this policy should take due account of the existing and future needs of the company's business. Capital formation rate, the rate at which the company adds to the capital after dividends, would determine accumulation of strength that the company demonstrates on a relative scale.

4. QUALITATIVE ASSESSMENT

- Effectiveness and independence of the board
- Risk tolerance of the management
- Efficacy of the control environment

4.1 Governance: PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of an individual entity's governance practices. PACRA considers the independence and effectiveness of the board of directors to be an essential element of a robust governance framework. The analysis includes an overview of the reasonableness of the executive and director remuneration in comparison with the market norms and standards, which also provides an insight into the relative financial discipline prevalent in the entity's culture and operations.

4.1.1 PACRA assesses the timeliness, quality and comprehensiveness of the information package which goes to the board members prior to each meeting. This enables the members to prepare themselves with reference to the agenda points and participate effectively in the meeting. The effectiveness of the discussion in the meetings and the aura of challenge therein are judged through the perusal of the board meeting minutes.

4.1.2 The committee structure of the board is evaluated in the context of the business needs of the company. PACRA understands that an effective board should delegate significant important tasks to each committee for an in-depth and productive deliberation.

4.2 Management: PACRA's assessment of management focuses on company strategy, risk tolerance and funding policies of the management. PACRA assesses management's track record in terms of its ability to create a healthy business mix, maintain operating efficiency and strengthen market position. PACRA also gives management significant credit for delivering on past projections or maintaining previously articulated strategies when evaluating future growth plans and related financial projections. The focus is to establish whether the company has a team or group of individuals. Team is defined by its cohesive vision and its ability to steer the company collectively. A high turnover is definitely a negative indication.

4.3 Control Environment: Another testimonial of the strong oversight and effective management is the control environment that the general insurer operator has instituted. PACRA considers that a good company should be driven by processes instead of being dependent upon individuals. Therefore, evaluation of the quality of policies and procedures and invariable adherence to those policies and procedures remain pivotal in the assessment of the control environment. Segregation of duties and occupancy of the all important positions would provide comfort as to the minimization of operational risk. With the passage of time, the importance of information technology infrastructure has increased tremendously. The companies that take advantage of advanced I.T. solutions deliver comparatively better on many fronts. PACRA, therefore, assesses the quality of the I.T. infrastructure and the breadth and depth of activities performed by this division. Herein, analysis of the integration of the company's operations into technology would be pivotal. One significant advantage of technology is the timely, precise and accurate MIS. The analysis of MIS being generated by the technology and its use by the department heads and the top management would underpin the comparative advantage (or disadvantage) that the company would have on a relative scale.

5. SPONSORS' SUPPORT

- Ongoing support vs. extraordinary support

5.1 PACRA classifies sponsors' support into two types: a) ongoing support b) extraordinary support. The ongoing support may come in multiple forms, for instance, technology, branding, and marketing. The ongoing support, being the continuing feature, would provide comfort in any of the relevant sections described above.

5.2 The extraordinary support denotes the support provided in unusual circumstances and may take the form of: i) liquidity injections during crisis, ii) subordinated loans to ease cash flow pressure, iii) recapitalizations to improve capital structure, iv) arrangement of a solvency rescue package through other market participants.

5.3 PACRA assesses the willingness and ability of the sponsors to provide extraordinary support and incorporate the benefit in the IFS rating of the general insurer/general *takaful* operator. The benefit reflects the extent of support and the legal mechanism in place to provide the support.

INFORMATION REQUIREMENT FOR IFS RATING

The following section illustrates the general set of information requirement for the IFS rating process. Depending on the historical performance, operational characteristics, and investment policies and strategies, some additional information may also be sought.

A. BUSINESS RISK

- The company's medium-term business plan including:
  a. Overall growth and diversification strategy, including the company's plan to launch new products
  b. Expansion plans in near term, including geographical spread, number of agencies and branches.
  c. Current and projected market share of the company
  d. Expected commission rates
  e. Targeted levels of cession and reinsurance arrangements
- Financial projections for three years along with detailed underlying assumptions and workings.
- Detail of gross premium written from 25 largest customers for each line of business
- Details of 25 largest claims intimated for each class of business separately.
- Details of 25 largest claims outstanding at period end, identifying period since outstanding and the reason for delay. Also (i) total sum to be covered under reinsurance arrangements in each segment and, (ii) estimated timeline by which your company expects to settle these claims.
- Amounts pertaining to disputed claims, while giving details of major disputed claims along with reasons.
- Total sum insured consolidated and for each category separately, and the net share of the company after re-insurance.
- Bank limits from each bank for each class of business
- With reference to investment portfolio,
  a) A brief write up on investment management framework; if available, Investment Policy (IPS) document,
  b) Break-up of investment book of the company as per the following format:

Scrip	No. of scrip	Date of maturing (if any)	Book Value	Fair Value	Surplus/deficit

B. FINANCIAL RISK

- Details of re-insurance including:
  a. Re-insurance arrangements and policies.
  b. List of "Treaties" along with the retention limits and details of surplus lines.
  c. Rates of commission received from re-insurers and contracted commission rates (separately for group and individual schemes).
  d. Number of policies above the retention limit and average amount of policy thereof.
- Ageing analysis of a) premiums due but unpaid, b) reinsurance recoveries against outstanding claims, c) provision for outstanding claims, and d) amount due to agents.
- Statutory returns submitted to SECP.

C. GOVERNANCE

- Profile of the Board of Directors.

- Minutes of the BoD meetings.

D. MANAGEMENT

- Latest organogram of the company.
- Profile of key management personnel as per pre-determined format.
- Minutes of the management committee meetings.

E. CONTROL ENVIRONMENT

- Brief write-up on core operating software.
- Copy of the management letter by external auditors.

F. SPONSORS

- Shareholding pattern of the company
- Brief write-up on history of the sponsoring group/s
- Other business ventures of the sponsoring group/s and their shareholding therein.
- Financial statements of the these business ventures

RATING SYMBOLS & DEFINITIONS:

INSURER FINANCIAL STRENGTH (IFS) RATING SCALE & DEFINITIONS

Insurer Financial Strength (IFS) rating reflects forward-looking opinion on relative ability of the insurance company to meet policyholders and contractual obligations.

Rating Scale	Definition
AAA	**Exceptionally Strong.** Exceptionally strong capacity to meet policyholder and contract obligations. Risk factors are minimal and the impact of any adverse business and economic factors is expected to be extremely small.
AA+ **AA** **AA-**	**Very Strong.** Very strong capacity to meet policyholder and contract obligations. Risk factors are modest, and the impact of any adverse business and economic factors is expected to be very small
A+ **A** **A-**	**Strong.** Strong capacity to meet policyholder and contract obligations. Risk factors are moderate, and the impact of any adverse business and economic factors is expected to be small.
BBB+ **BBB** **BBB-**	**Good.** Good capacity to meet policyholder and contract obligations. Although risk factors are somewhat high, and the impact of any adverse business and economic factors is expected to be manageable.
BB+ **BB** **BB-**	**Moderately Weak.** Moderately weak with an uncertain capacity to meet policyholder and contract obligations. Though positive factors are present, overall risk factors are high, and the impact of any adverse business and economic factors is expected to be significant.
B+ **B** **B-**	**Weak.** Weak capacity to meet policyholder and contract obligations. Risk factors are very high, and the impact of any adverse business and economic factors is expected to be very significant.
CCC **CC** **C**	**Very Weak.** Very weak with a very poor capacity to meet policyholder and contract obligations. 'CCC': Risk factors are extremely high, and the impact of any adverse business and economic factors is expected to be insurmountable. 'CC': Some form of insolvency or liquidity impairment appears probable. 'C': Insolvency or liquidity impairment appears imminent.
D	**Distressed.** Either failed to make payments on their obligations in a timely manner, are deemed to be insolvent, or have been subjected to some form of regulatory intervention. Limited liquid assets available to fund obligations.

Outlook (Stable, Positive, Negative, Developing)
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension
It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future but may stay in abeyance for long. However, if this does not happen 6 (six) months, the rating should be considered withdrawn.

Withdrawn
A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, or c) the rating remains suspended for six months.