The Pakistan Credit Rating Agency Limited

General Insurance & Takaful Operator – Insurer Financial Strength (IFS) Rating

Specialized Rating Methodology

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Summary

PACRA 's Insurer Financial Strength rating for General Insurance Companies is a representation of its opinion on a general insurer's relative ability to meet policyholders and contractual obligations. The opinion is not specific to any particular insurance policy or contract but reflects the overall ability of the general insurer. This opinion is arrived at by evaluating the general insurer's ownership, governance, management, business risk and financial risk. Overall, PACRA has a more favorable opinion on insurance companies, which have strong Enterprise Risk Management, relative position, persistency, robust underwriting performance, investment, liquidity and reinsurance arrangements.

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0. Introduction

- Qualitative and quantitative factors
- All factors are assessed on standalone and relative basis.

0.1 Scope: Insurer Financial Strength (IFS) rating of a general insurer is assesses a general insurer/general takaful operator's[1] relative ability to meet policyholders and contractual obligations. 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 general insurers. PACRA understands 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 financial strength rating is assigned to the general insurer itself, and no liabilities or obligations of the general insurer are specifically rated unless otherwise stated.

0.1.1 The financial strength rating does not address the willingness of management to honor general insurer's obligations, nor does the rating address the quality of general insurer'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.

0.1.2 Although this methodology follows a distinct analytical approach compared to life insurance ratings, 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 have same notational values along with 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 sharia advisors of the general insurer. 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 but rather on its ability to meet obligations towards policy holders.

0.2 Rating Framework: The liabilities a general insurer covers belong necessarily to the future period. Therefore, it is utmost critical that the financial indicators of the general 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 to ensure comparability between ratings over time. Overall factors are categorized under these key areas: Profile, Ownership, Governance, Management, Business Risk and Financial Risk.

0.2.1 In August 2022, the SECP introduced a registration regime for digital-only insurers and dedicated micro insurers to promote digitalization and innovation. This framework is expected to enable expansion of insurance product range in Pakistan and greater financial inclusion. The factors described in this methodology apply to traditional as well as digital insurers.

[1] In this document, the term "General Insurer" denotes both general insurer and takaful operators wherever these are not separately mentioned

1. Profile

- **Background:** Evolution and past strategy
- **Operations:** Key facts including nature of business, product slate, geographical location, etc.

1.1 Background: PACRA reviews the background of the general insurer to understand its evolution from where it started to where it currently stands. We analyze how and through what means the general insurer has achieved the desired expansion. PACRA looks at the progress of the general insurer from its historical past. The progress of the general insurer helps PACRA in determining the ability of the general insurer to successfully realize its strategy. The significant factor here for PACRA is to assess whether the general insurer has achieved the desired expansion through organic growth or acquisitions. Meanwhile, the source of funding for desired growth is also critical.

1.2 Operations: The assessment of operations of general insurer depends on the exposure of business segments and the life cycle stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, product offering, size of the franchise/portfolio, track record of operations adherence to standard operating procedures and policies and protocols. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

2. Ownership

- **Ownership Structure:** Identification of man at the last mile.
- **Stability:** Succession planning at shareholder level
- **Business Acumen:** Knowledge, skills and experience of key shareholders
- **Financial Strength:** Willingness and ability of key shareholders to provide extra-ordinary financial support

2.1 Ownership Structure: The assessment of ownership begins by looking at the legal status of the general insurer. The level of perceived stability gradually increases from a sole proprietor to a listed company. This is followed by an in-depth study of the shareholding mix in order to disentangle structure of ownership. Key factors that are considered for this purpose, inter-alia, include: i) shareholding structure which includes whether the individual(s) own the general insurer directly or indirectly, ii) foreign or local shareholders, iii) whether the general insurer is owned by a single group or through a combination of entities and individuals, and iv) whether it is part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile. PACRA further considers how the general insurer is actually run, as, at times, entities are run as family concerns despite being legally structured as companies.

Complex shareholding/ownership structures: *In cases where the general insurer has a complex ownership structure, there are unique challenges in evaluating the decision-making process, lines of hierarchy and financial obligations and liabilities. In analyzing these companies, the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

Insurance companies which are owned by private individuals and families: *On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting funds from the general insurer as source of income or to fund other business activities, potentially undermining the financial stability of the general insurer.*

2.2 Stability: In order to analyze the stability of ownership, a particularly important factor to be taken into account is succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, the general insurer's prospects would be supported and by whom. This is particularly relevant in case of family-owned businesses and joint ventures, whose failures could have a contagious effect on the sustainability of the general insurer. A stable ownership with clarity in succession, perhaps major stakes residing with one family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to risk of take over and may anchor lower ratings.

2.3 Business Acumen: Here PACRA gauge the Sponsor's business skills. Having a strong business skill set has been critical for the sustainable success of the general insurer. PACRA analyze the business acumen through two primary areas; i) Industry-specific working knowledge and ii) Strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical in order to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the apex of the general insurer think about and successfully make the right business decisions.

2.4 Financial Strength: PACRA analyzes the ability and willingness of the major shareholders to support the general insurance company both on a continuing basis, and support in times of crisis. Here, PACRA gives due importance to: i) behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, ii) prospective view of key shareholders, incase such need arises, iii) other businesses of sponsors, and iv) the level of commitment of the major shareholder with the general insurer in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. The scope for looking at other business of sponsors includes overall profiling of the key sponsors in the context of identifying the resources they have, outside the general insurer. Here, the standalone rating of the institution can benefit from having majority shareholders with very strong financial strength and commitment to the business. If, in a group structure, the financial strength of the sponsor is deemed to be weaker than that of the general insurer, this may bode negatively for the general insurer's standalone rating given the possibility that the general insurer may at some point of time be bound to extend financial support to its weaker parent.

Information Required on Ownership:
- Shareholding pattern
- Details of major shareholders' other businesses
- Shareholders' financial information
- Past pattern of support provided by the shareholders

3. Governance

- **Board Structure:** Composition of board in terms of size, independence and committees
- **Members Profile:** Relevance and diversity of board members' skills, knowledge and experience
- **Board Effectiveness:** Extent to which board properly discharges its responsibilities
- **Transparency:** Quality and extent of financial and non-financial information

3.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, and duration of board members' association with the general insurer, overall skill mix and structure of board committees. Size of the board may vary as per the scope and complexity of the operations of the general insurer. While a very small board is not considered good, similarly, reaching a decision in an effective and efficient manner may not be possible in case of a large board. A healthy composition of board includes the presence of independent/non-executive members having limited relationship with the sponsoring group of the general insurer. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also examines the independence of governance from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees provide support to the board. A board with higher number of members should have higher number of committees in place to assist in performing its role.

3.2 Members' Profile: PACRA collects information regarding profile and experience of each board member. This helps in forming an opinion about the quality of overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have related experience.

3.3 Board Effectiveness: In PACRA's view, the role of the board is to work with management in steering the general insurer to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared disclosure to stake holders

with board members, and quality of discussions taking place at board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year as these should be justified with the number of issues/matters arising. Board members' attendance and participation in meetings is important, and is gauged by viewing board meeting minutes.

3.4 Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved through: i) ensuring independence of the audit committee, ii) strengthening the quality of internal audit function, which may be in-house or outsourced, and iii) improving quality of external audit by engaging auditors which are included in the State Bank of Pakistan's panel of auditors and/or have a satisfactory QCR rating.

***Accounting Quality**: PACRA reviews the quality of the general insurer's accounting policies as reflected in its notes to accounts, auditors' comments and other disclosures which are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.*
***Quality of Disclosure**: A well-established information system is required for adequate disclosures. The characteristics of quality information includes timelines, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures*

Information Required on Governance:
- Size and composition of board
- Details of board committees including TORs
- Profile of board members
- Information packs used by the board
- Minutes of board meetings
- Internal auditor detail (if outsourced) and External Auditor detail

4. Management

- **Organizational Structure:** Alignment of organogram with entity size, nature of business and requirements
- **Management Team:** Relevance and diversity of skills, knowledge and experience of top management
- **Management Effectiveness:** Extent to which top management properly discharges duties and role of technology

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the general insurer. On a standalone basis, PACRA looks into the hierarchal structure, reporting line, dependence of the management team on one or more persons, coherence of the team. However, PACRA also places the organizational structure in the general insurer's relative universe for comparison in order to form opinion of optimal structure within the sector in context of its complexity. Number of management committees are established to monitor performance assure the adherence to the policies and procedures. PACRA measures the effectiveness of the general insurer by forming an opinion on the quality of management committees.

4.2 Management Team: Analysis of management includes evaluating experience profile of key individuals, management's track record to date, in terms of building up sound business mix, maintaining operating efficiency and strengthening the general insurer's market position. Although judgment about management team is subjective, performance of the general insurer over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the general insurer relative to peers. Hence, HR turnover is to determine the stability of critical staff, with particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, the general insurer's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

infrastructure therein
- **Claim Management System:** Quality, Independence of claims handling department
- **Investment Management Function:** Structure and profile of investment function, quality of investment policy
- **Risk Management Framework:** Independence and effectiveness of risk management system
- **Enterprise Risk Management:** Integration of risk management approach throughout operations

Field Staff: *The role of mid- and low-tier staff is critical in maintaining relationship with the policy holders. Any misconduct on their part may lead to deterioration in the institution's underwriting or retention of business. Thus, the general insurer's ability to retain good field staff is considered important while assessing human resource management. Moreover, PACRA attempts to understand the client's staffing policies, local language ability of the staff dealing with prospective clients and policy holders, and their training on social aspects.*

Key-person Risk*: Key-person risk occurs when a general insurer is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge or relationships. While this type of risk is more common in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which the general insurer is dependent on the expertise of such individual(s) and to ensure policies exist for succession/redundancy to limit the adverse impact of such a person unexpectedly leaving the insurer.*

4.3 Management Effectiveness: PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. It is critical that information available to management be concise, clear and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the general insurer's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate performance of various business segments, and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of discussion.

MIS*: System generated – real-time based – MIS reports add more efficiency in decision making whether related to operational, financial or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the general insurer is information-based.*

4.4 Claim Management System: The Claims department has to be independent of underwriting and marketing. It must be resourced fully both in terms of manpower and infrastructure including MIS. A senior, experienced and independent Head of Claims can ensure that the mandate of Claims department is fulfilled.

Claim Settlement System: *Claim settlement begins with the recording of the claim. Claims need to be booked immediately and without discrimination in the books of account; related provisions to be created and claims need to be tracked along the settlement process. Efficient claim settlement process depends a lot on technology integration. With technology, all stakeholders may be fully aware as to the stage and time further required for the settlement. Turn-around time important for a single claim and for the portfolio of claims; this can be monitored through detailed MIS reports.*

4.5 Investment Management: PACRA evaluates the investment management function on aspects, including: i) structure of function, ii) experience of staff, iii) investment policy and iv) role of MIS. PACRA places emphasis on the quality of the investment committee and expertise of the investment manager. The investment committee must include members who are savvy to investment decision making while the investment managers must also be experienced and well entrenched into the equity and debt market depending upon the portfolio of the insurance company.

In addition, investment policy statement, duly approved by the Board, is the document that lays down the investment philosophy of the general insurer. PACRA assesses whether the statement covers key areas such as i) proposal generation, ii) decision making, iii) investment allocation, iv) benchmarks, and v) performance evaluation.

Market Risk: *PACRA's analysis of market risk incorporates structural risks (such as interest-rate risk management) and/or trading risks where present. Scrutinizing the duration of the general insurers' liabilities compared to its assets is crucial. PACRA reviews the asset and liability management strategy to assess the risk appetite of the general insurer. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure an general insurer's ratings.*

4.6 Risk Management Framework/Control Environment: This includes an analysis of the general insurer's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems, in the face of increasing guidance and supervision from SECP. Insurance companies are primarily governed under the Insurance Ordinance, 2000.

4.6.1 Enterprise Risk Management: PACRA evaluates the ERM to assess whether general insurer executes risk management practices across the enterprise in a systematic and consistent manner. Our primary focus is to access whether a general insurer addresses risk through silos i.e., each risk area is conducted as narrowly focused and fragmented activities or instead adopts an integrated approach across all functions. PACRA also assesses the extent to which a general insurer effectively limits key risks within its appetite to optimally achieve its business goals and objectives. The ERM assessment consists of four sections: role of the board, risk culture, risk exposure management, and risk optimization.

Operational Risk: *In the context of Basel II and Basel III, operational risk is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events"[2]. Our analysis of operational risk focuses on a number of issues, including (a) insurer's definition of such risk, (b) the quality of its organizational structure, (c) operational risk culture, (d) approach to the identification and assessment of key risks (e) data collection efforts, and (f) overall approach to operational risk quantification and management. Extent of technological integration is considered crucial in mitigation of operational risks such as fraud, cyber risk, loss of data and technological disruptions in critical processes. High degree of automation in day-to-day operations is considered favorable to operational risk management.*

Reputation and Other Risks: *Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate but could adversely affect the general insurer's rating in cases where it is significant. In addition to reputation risk, any regulatory non- compliance may lead to legal risk with potential ramifications as well.*

[2] BIS: Basel Framework, Chapter OPE - Calculation of RWA for operational risk

Information Required on Management:
- Latest organogram
- Profile of senior management
- Redundancy pattern
- MIS reports
- Management meeting minutes
- General Insurer's policies and SOP
- A brief write-up on technological infrastructure and claim management system
- A brief write-up on risk management framework and investment management framework

5. Business Risk

- **Industry Dynamics**: Systematic risks and opportunities in operating environment
- **Relative Position**: **Current** standing among peers
- **Revenues**: Volume, stability and diversification of inflows from core and non-core operations
- **Investment Performance**: Relative investment performance, risks associated with concentrated, volatile, and illiquid investments
- **Cost Structure**: Key costs and associated risks, as well as ultimate impact on profitability
- **Sustainability: Soundness** and viability of long-term strategy

5.1 Industry Dynamics: The process for IFS rating of the general insurer's builds on PACRA's understanding of the general insurer's 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 regulatory environment and likely support, if needed.

Economic Risk: *PACRA analyzes basic economic indicators of the country including size and composition of economy, performance of important sectors, gross domestic product (GDP) growth, inflation, saving and investment trends. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.*

Regulatory Environment: *A well-regulated and supervised system is pivotal for credibility and stability of the general insurer even when the operating environment is unfavorable. PACRA's evaluation of the regulatory system involves evaluation of criterion related to capital and other countercyclical measures to absorb risk and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes.*

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

Market Share: *Market size represents the general insurer'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 general 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 general insurer's standing in the related market. Having said that, size for the sake of size is not worth it, if the general* *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 while sustainable growth is viewed positively.*

Growth Trend: *While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the general 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.*

Brand Value: *General 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 general 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 general insurer to strengthen its market share, ensure comparative growth rate and enjoy healthy margins. While a stronger combination of these enables the general 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 general insurer.*

5.3 Revenues: PACRA's analytical approach starts with an assessment of product-wise underwriting contribution, which provides a good indication of the returns generated by the general insurer's business segments. In measuring earning's quality of the general insurer, diversification and stability are very important factors. A general insurer with a diverse product slate with more than one revenue streams is considered better than a general insurer with a concentrated earning profile. However, in case of mono-line business, PACRA evaluates their expertise and track record. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which the general insurer serves forms a part of the assessment. Stability is measured through historical trend analysis of the general insurer's revenues. Total revenues of general insurer's are a combination of its underwriting result and its investment income.

Diversification: Diversification is desirable since it enhances the general insurer's ability to meet challenges, both present and upcoming. Lack of diversification gives rise to concentration risk, reflecting vulnerability of the general insurer's, to few elements. At the same time, it enhances the risk of disruption in if the area of concentration goes wrong. This does not entail that the insurer specializing in a certain product/segment would necessarily be at a disadvantage. The disadvantage would only arise if the general insurer's business gives rise to concentration risk. At the same time, diversification into riskier segments may not improve resilience and, therefore, may not translate into superior ratings. Based on this understanding, PACRA places high emphasis on diversification of premium across key segments such as Fire, Marine, Motor, Health and others. Within others, a balanced mix of all contributing elements would be appreciated.

5.4 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 general insurer'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.

Quality of Investment Book: *The quality of the investment book is assessed to form an opinion on whether investments are concentrated in high-risk avenues. Apart from the equity investments, which are otherwise viewed in the context of the overall risk appetite of the life insurer, the remaining investments are evaluated from the perspective of the credit profile of the investee. Life insurers generally invest in long-term government securities. Investment in equities, if any, usually form a minor portion of the investment portfolio.*

Investment Income Contribution: *Investment income is the alternative revenue stream. It supplements the general insurer's profitability. This is the profit which an insurance company makes over and above the underwriting income or loss, measured through combined ratio. Investment income contribution is computed by comparing the investment income against the underwriting income. Stronger companies make more money from investments; good companies match investment income to underwriting income.*

Yield: *PACRA evaluates the performance of the investment portfolio. It shows whether the general insurer is underperforming, meeting or exceeding the relevant benchmarks.*

Strategic Investments: *Strategic Investments are considered good when these are cash producing; when these are cash consuming these provide pending pressure on the liquidity. PACRA assigns score in terms of percentage of cash producing investment to cash consuming investment.*

5.5 Cost Structure: Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the general insurer’s performance ratios relative to those of its peers to understand whether costs have been contained while growing assets and revenue. If expense ratios are high, it could be an indicator that the insurer has a significant fixed cost burden. In this context, key measure that PACRA looks at is the expense ratio. [(Net commission and other acquisition costs + Management expenses) / Net insurance premium]. Performance measures are not assessed in isolation as there may be variations that are caused by business model differences and the importance of ongoing investment in the general insurer’s franchise. A low-cost base relative to peers offers the general insurer greater flexibility to deal with competitive pricing pressures.

Margins: *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 general 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.*

5.6 Sustainability: Earning prospects are also monitored, based on budgets and forecast prepared by the general insurer. A reality check is performed while analyzing underlying assumption taken by the management as well as management’s track record in providing reliable budgets and forecasts.

***Event Risk**: Incorporating the risk of unforeseen events into general insurer's rating opinion is challenging, given their unpredictable nature and magnitude of impact of the underlying event. These events may be external (e.g., M&As, regulatory changes or a natural disaster) or may be internally driven (unrelated diversification, system breakdown leading to significant operational risk or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences and potential impact, insofar as may be possible, and assesses the general insurer's track record, expertise of management team and level of financial discipline to incorporate the same into its ratings.*

Information Required on Business Risk:
- Detail of gross premium written from 10 largest customers for each line of business
- Details of 10 largest claims intimated for each class of business separately
- Total sum insured consolidated and for each category separately, and the net share of the company after reinsurance
- The general insurer's medium-term business plan
- Rates of commission received from re-insurers and contracted commission rates
- Financial projections for next two years

6. Financial Risk

- **Claims Efficiency**: Claims payment patterns, outstanding claims and non-payment risk associated to it.
- **Re-Insurance:** Current state of reinsurance and its concentration associated with re-insurer, outstanding receivables at re-insurer's end, credibility of re-insurer.
- **Liquidity:** Sufficiency of liquidity against claims, liquid investments, quality of investments and cash collection from operations
- **Capital Structure:** Current & forecasted Capital adequacy

6.1 Claims Efficiency: The underlying risk that the insurer financial strength rating covers is the risk of claims not being met by the general 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. PACRA believes that general insurers having higher rating would be carrying lower number 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 periods instead of their accumulation to a single year. This safeguards the general insurer from building an undue pressure on the liquidity of the company in any specific period.

6.2 Re-insurance: The re-insurance is the risk coverage obtained by the general insurer against insurance claims. Herein, business philosophy of the general 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.

6.2.1 PACRA looks deeply into the receivables to be recovered from the reinsurers. The analysis of the amount of general insurer's reinsurance recoverable, its concentrated reliance on a few reinsurers, and the credit quality of the individual reinsurers is important because write-offs of the recoverable as uncollectible could impact the general insurer's income and capital, and because the loss of reinsurance capacity could require the general insurer to modify its market/product focus.

PACRA looks at what kind of rating the re-insurer enjoys, their experience in the Pakistani market, their historical relationship with the general insurer, treaty terms, and their respective share in the reinsurance pool.

6.3 Liquidity: The liquidity profile of the general 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 insurance company. While exposure towards the equity market may be determined by the investment philosophy of the general insurer, PACRA relates the extent of exposure with the overall risk profile of the general 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 general insurers' liquidity requirement and attractiveness of the book for disposal.

Admissible Assets: *Admissible assets are calculated under SECP guidelines. These assets provide risk absorption capacity. These assets are compared to total liabilities, to determine solvency of the general insurer.*

6.4 Capital Structure: At the heart of PACRA's financial risk assessment lies the adequacy of the capital for the general 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 general insurer's business model. This understanding stems from the realization that the general insurer following a high risk and high growth business strategy would need entirely different capital requirement as against general insurer following a conservative business model.

6.4.1 In December 2022, the SECP issued a concept paper on the proposed shift from the current rule-based capital adequacy framework towards a risk-based capital regime for Pakistan's insurance sector. This transition is envisioned to ensure that the level of capital maintained by an insurer is commensurate with the level of risk undertaken by it. This is expected to more accurately reflect various risks and capital buffers for individual insurers. The new regime would result in the Capital Adequacy Ratio (CAR) becoming a key metric in determining the loss absorption capacity of an insurer. While the capital adequacy levels have not yet been defined, PACRA will consider the applicable regulatory regime, once implemented, in its assessment of the insurer's capital structure.

6.4.2 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 general insurer 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 general insurer's business. Capital formation rate, the rate at which the general insurer adds to the capital after dividends, would determine accumulation of strength that the general insurer demonstrates on a relative scale.

Credit Enhancement: *The general insurer that carry third party commitment to make good an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.*

Information Required on Financial Risk:

- Re-insurance arrangements and policies
- List of "Treaties" along with the retention limits and details of surplus lines
- 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
- Details of 10 largest claims intimated for each class of business separately
- Total sum insured consolidated and for each category separately, and the net share of the general insurer after reinsurance
- Details of 10 largest claims outstanding at period end, identifying period since outstanding and the reason for delay
- Amounts pertaining to disputed claims, while giving details of major disputed claims along with reasons

Insurer Financial Strength (IFS) Rating

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

Scale	Definition
AAA (ifs)	**Exceptionally Strong.** Exceptionally Strong capacity to meet policy holders and contract obligations. Risk factors are minimal, and the impact of any adverse business and economic factors is expected to be extremely small.
AA++ (ifs) AA+ (ifs) AA (ifs)	**Very Strong.** Very Strong capacity to meet policy holders and contract obligations. Risk factors are very low, and the impact of any adverse business and economic factors is expected to be very small.
A++ (ifs) A+ (ifs) A (ifs)	**Strong.** Strong capacity to meet policy holders and contract obligations. Risk factors are low, and the impact of any adverse business and economic factors is expected to be small.
BBB++ (ifs) BBB+ (ifs) BBB (ifs)	**Good.** Good capacity to meet policy holders and contract obligations. Risk factors are moderate, and the impact of any adverse business and economic factors is expected to be manageable.
BB++ (ifs) BB+ (ifs) BB (ifs)	**Modest.** Modest capacity to meet policy holders and contract obligations. Though positive factors are present, risk factors are relatively high, and the impact of any adverse business and economic factors is expected to be significant.
B++ (ifs) B+ (ifs) B (ifs)	**Weak.** Weak capacity to meet policy holders and contract obligations. Risk factors are high, and the impact of any adverse business and economic factors is expected to be very significant.
CCC (ifs) CC (ifs) C (ifs)	**Very Weak.** Very weak capacity to meet policy holders and contract obligations. Risk factors are very high, and the impact of any adverse business and economic factors may lead to insolvency or liquidity impairment
D (ifs)	**Distressed.** Extremely weak capacity with limited liquid assets to meet policy holders and contract obligations, or subjected to some form of regulatory intervention or declared insolvent by the regulator.

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 some material identifiable event with indeterminable rating implications. 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 rating 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. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

Note. This scale is applicable to the following methodology(s): General Insurance & Takaful Operator, Life Insurance & Family Takaful Operator.