METHODOLOGY

LIFE INSURANCE & FAMILY TAKAFUL OPERATOR-INSURER FINANCIAL STRENGHT (IFS)

An opinion on the ability of the life insurer / family operator to meet policy holder obligation.

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0. INTRODUCTION

- *Scope*
- *Rating Framework*

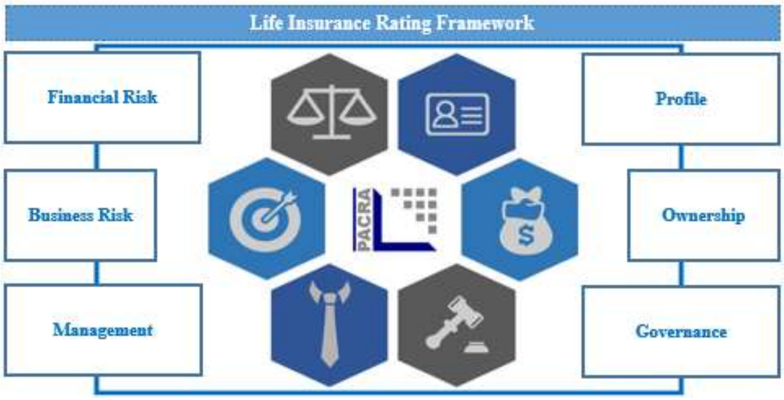
A sound financial ecosystem is critical for functioning of any economy. It is defined by interaction of providers of funds - savers, users of funds - borrowers, financial institutions, and regulators. This system ensures smooth flow of funds between savers and borrowers; wherein, financial institutions provide platform for their interaction. Regulatory oversight safeguards the sanctity of this system. Like all systems, financial system has its own set of challenges. The most prominent being "Risk"; the risk that some participant may not be able to meet its commitments. All participants do their best to manage this risk to maximize their return. This is not possible unless we have independent information on this risk. Here comes expertise of rating agencies, providing independent opinion on credit risk. Flow of funds is only possible when the provider of funds has confidence that user of funds will be able to return these in a timely manner and as committed. Ratings help build this confidence. A higher rating means higher likelihood of timely repayment compared to a low rating. Our ratings are forward-looking and reflect our expectations for future financial and operating performance. However, historical results are helpful in understanding patterns and trends of a company's performance as well as for peer comparisons.

0.1 Scope: The private sector was allowed to enter the life insurance market in the early 90s. It compares favorably with the Indian market where the state owned life insurer – Life Insurance Corporation controls ~70% of the market. Despite this comparability, the sector lags in terms of both penetration and density not only with the International market but also with India and other regional markets. This highlights the growth potential as well as the extent of challenge that the sector is facing. Over the last couple of years, the growth rate has been exponential. This reflects the players' ability to identify untapped market segments and capitalize on them. Unlike the general insurance, the fundamental target audience being the retail market poses a specific challenge to the industry. Yet diversity in distribution channel and effective utilization of available resources has provided impetus to the growth momentum. Family *takaful* operators, following the *shari'ah* principles, are also strengthening their foothold in the market. The business model, though having intrinsic strengths, may take a longer gestation period depending upon the extent of emerging competition.

0.1.1 PACRA is alive to the distinction that life insurance carries with respect to its risks and challenges despite its generic commonality with general insurance business. PACRA recognizes the need to document its approach towards rating the life insurance companies and family *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].

0.1.2 Although this methodology has distinct approach towards analysis and synthesis, the rating scale on which life insurers' ratings are placed are the same as that for general 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 life insurance companies and family *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 family *takaful* operator would not be an opinion on the accuracy of the *shari'ah* principles and quality of operator's adherence to these principles.

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



0.2 Rating Framework: PACRA's framework for assessing credit quality makes use of both qualitative and quantitative analyses. Overall factors are categorized under these key areas.

0.2.1 The life 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.

0.2.2 Because life insurers operate with the same corporate structure, the fundamental concept applicable to corporate ratings apply to life insurers as well. This means that the ownership of the company, its board structure, the quality of management and the efficacy of the control environment would all be assessed besides deliberating upon the business risk and financial risk of the insurer. PACRA believes that short tail risks (or strengths) arise from the business and financial profile of the company while sustainability and longevity is a function of qualitative parameters.

1. PROFILE

- *Structure*
- *Background*
- *Operations*

1.1 Structure: PACRA evaluates the legal structure of the entity. Legal status determines the level of expected stability. In cases where the entity is a large financial institute and has a complex business structure, there are unique challenges in evaluating credibility of the entity. PACRA considers the characteristics of the entity as at times a public company structure might operates like a private company. Meanwhile, the level of perceived stability gradually increases from a private entity to a listed entity. However, unnecessary complex structures when compared to asset size, scale and peers of the same industry would have an adverse effect on the credit scoring of the entity.

1.2 Background: PACRA looks at the progress of the entity since its inception in order to understand the evolution of the entity from where it started to where it currently stand at. The background of the entity helps PACRA in assessing how and through what means the entity has achieved the desired expansion. However, it also help PACRA in establishing the scope of work in terms of its complexity.

1.3 Operations: The assessment of operations of the entity depends on the type of the industry and the stage the business is in. Here PACRA reviews the diversity, geographic spread of operations, and diversification of major borrowers and lenders. Later, PACRA places the entity within its relative universe to evaluate critical factors that provide competitive advantage. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

2. OWNERSHIP

- *Structure*
- *Stability*
- *Business Acumen*
- *Financial Strength*

2.1 Structure: The assessment of ownership begins with an in-depth study of the shareholding mix in order to disentangle structure of the ownership. Key factors that are considered for this purpose, inter-alia include, i) shareholding structure which includes whether the individual own the entity directly or indirectly, ii) foreign or local shareholders, iii) whether the entity is owned by a single group or through a combination of entities and individuals, and iv) part of a group or a standalone entity. All these deliberations are done to identify the man of the last mile.

Complex shareholding/ownership structures: *In cases where an entity 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 entity's the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.*

Financial Institutions 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 entity as source of income or to fund other business activities, potentially undermining the financial stability of the entity.*

2.2 Stability: In order to analyze the stability of the ownership, a particularly important factor to be taken into account is the succession planning. A very important part of our background analytical work is an attempt to assess whether, and under right of succession, an entity future prospects would be supported, and by whom. This is particularly relevant for support in case of larger sized banks, whose failures could have a contagious effect on the confidence in the overall financial system.

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 entity. 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 entity think about and successfully make the right business decisions.

2.4 Financial Strength: We analyze the ability and willingness of either its owners or the government / regulator to bail out the entity in case of need. Particularly in case of small financial institute, where capitalization requirements are yet to meet by the entity, PACRA critically analyses the willingness and ability of the major shareholder to support the entity to comply with regulatory requirements within required timeframe. Thus ongoing support is considered more likely in these cases. However, for large financial institutions, external support from government / regulatory becomes more important. Here, PACRA gives due importance to, i) the 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 entity in providing capital support. In case of no explicit commitment, PACRA attempts to form a view on availability of likely support. The scope for other business of sponsors includes overall profiling of the key sponsor in the context of identifying the resources they have, outside the entity.

Information Required

- *Shareholding Pattern*
- *Details of sponsors' other businesses*
- *Sponsor's financial information*
- *Past pattern of sponsor support*

3. GOVERNANCE

- *Board Structure*
- *Members' Profile*
- *Board Effectiveness*
- *Financial Transparency*

3.0 PACRA's assessment of governance involves both systematic analyses of governance data and information, and the more contextual reviews of an entity's governance practices. PACRA considers four main factors while assessing the board structure of an entity: (i) board structure, (ii) members profile, (iii) board effectiveness, and (iv) financial transparency.

3.1 Board Structure: This comprises assessment of board on various criteria including overall size, presence of independent members, association of board members with the entity, overall skill mix and structure of committees of the board. Size of the board may vary as per the scope and complexity of the business operations of the entity. As too small board is not considered good, similarly reaching on a decision in an effective and efficient manner may not be possible in case of a larger board. A healthy composition of board includes the presence of independent / non-executive members having limited relationship with the sponsoring group of the entity. Meanwhile, same individual holding chairman and CEO positions is considered weak governance practice. Thus these should be separate persons. The chairman is expected to have a non-executive role.Compliance of code of corporate governance is also examined. Here PACRA also examines the independence of management from major shareholders. Lastly, PACRA evaluates number of board committees, their structure, and how these committees are providing support to the BoD. The board with higher total number of members should have higher number of committees in place to achieve efficiency in performing role of the board.

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. Here, director's trainings conducted by the entity are considered good. This is expected to equip the board members in fulfilling their role in an effective manner.

3.3 Board Effectiveness: PACRA considers the role of the board is to work with management in steering the entity to its performance objectives and to provide critical and impartial oversight of management performance. Board members' attendance and participation in meetings is considered a measure to assess the effectiveness. Moreover, PACRA analyses the type and extent of information shared with the board members, and quality of discussions taking place at board and committee level. Effective oversight requires frequent sharing and detailed information than required by statue. Meanwhile, PACRA also review the number of board meeting held during the year as number of board meetings should be justified with the number of issues/matters arising.

3.4 Financial Transparency: Quality of governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial information. The board may establish controls to ensure transparency through strengthening the role of audit committee, the quality of internal audit function, and effectiveness of external audit.

Information Required

- *Profile of BoD members*
- *Details of committees including TORs*
- *Minutes of the board meetings*
- *Information packs for the boards (MIS)*
- *Auditor details*

4. MANAGEMENT

- ***Organizational Structure***
- ***Management Team***
- ***MIS***
- ***Claim Management System***
- ***Investment Management Function***
- ***Risk Management framework***

4.0 Good quality management, effective systems and controls, and well-defined strategy are essential ingredients for a successful entity.

4.1 Organizational Structure: The assessment of management starts with PACRA conducting an in-depth analysis of organizational structure of the entity. 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 entity'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 and assure the adherence to the policies and procedures. PACRA measures the effectiveness of the entity 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 entity's market position. Although judgment about management is subjective, performance of entity over time provides a more objective measure. PACRA analyses the quality and credibility of management's strategy, examining plans for internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and sticking to strategies. Loss of key personnel, particularly members of senior management, can have potentially adverse effects on overall standing of the entity relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. In addition, entity's human resource policies are also reviewed to gauge entity's emphasis on retaining and recruiting vital staff and ensuring their redundancy in the structure.

Field Staff: *In case of General Insurance, the mid- and low-tier staff is critical in maintaining a strong asset quality as they hold the relationship with the policy holder and any misconduct on their part may cost deterioration to the institution's credit quality. Thus their 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 staff dealing with prospects and policy holders, and their training on social aspects, particularly important to the area of their operations.*

4.3 MIS: One of the key tools available to the management to effectively run an organization is the information provided to it. PACRA closely monitors the type and frequency of information used by the management. The critical aspect is for the information to be concise, clear, and timely so the management can understand and respond accordingly. System generated – real time based – MIS reports add more efficiency in performance monitoring. PACRA evaluates the quality and frequency of the MIS reports used by the department heads. PACRA further assesses whether management has developed any critical success factors (CSF) to evaluate performance of various business segments. The efficacy of these CSF is gauged.

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. Surveyor appointed. 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 is important for a single claim and for the portfolio of claims; this can be monitored through detailed MIS.*

4.5 Investment Management Function: Investment management function comprises of four steps which include i) Structure of function ii) Experience iii) Investment policy and iv) MIS system. PACRA evaluates two the investment committee and investment manager and believes a good insurance company has both of these. The Investment Committee must include members who are savvy to investment decision making. Investment Manger 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 company. It should clearly cover areas such as i) proposal generation, ii) decision making, iii) investment allocation, iv) benchmarks, v) performance evaluation.

4.6 Risk Management Framework: This includes an analysis of the entity'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 of the financial institutes, in the face of increasing guidance and supervision from the SBP and SECP.

Operational Risk: *Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II, definition of operational risk is: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events". This definition includes legal risk but excludes strategic and reputation risk.*

Our analysis of operational risk focuses on a number of issues, including (a) an entity's definition of such risk (b) the quality of its organizational structure (c) operational risk culture (c) the development of its approach to the identification and assessment of key risks (d) data collection efforts; and (e) overall approach to operational risk quantification and management.

Other Risks: *As already indicated, a risk often not encapsulated in the above categories is reputation risk, which can be significant for some entities, particularly those active in private banking. A good name and brand image are often an important differentiator of long-term performance in an industry which is becoming increasingly commoditized.*

Information Required

- *Latest Organogram*
- *Profile of senior management*
- *Redundancy pattern*
- *MIS reports*
- *Management meeting minutes*
- *Entity's policies and SOP*
- *A brief write up on investment management framework*
- *A brief write up on claim management system*

5. BUSINESS RISK

- ***Industry Dynamics***
- ***Relative Position***
- ***Persistency***
- ***Revenue***
- ***Profitability***
- ***Investment Performance***
- ***Sustainability***

5.0 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.

5.0.1 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 surplus (or deficit) arising from the underwriting and investment operations. There are four components of financial statements to consider in case of life insurer/family takaful operator, namely, i) shareholders' fund, ii) profit and loss account, iii) statutory fund and iv) revenue account. While the first two represent the company's own balance sheet and income statement, the last two reflect underwriting business of the company.

5.02 PACRA believes that the business risk of a life insurer operator resides in the revenue account, which implies that profit and loss account of the life insurer should be viewed independently. This approach stems from an understanding that the fundamental viability of a life insurer emanates from the underwriting operations and the investment income from the premium/investment float. This is core to the business of the insurer. The shareholders' fund[2], hence revenue account, represents a cushion that may be utilized to provide support to the insurer in initial days or distressed times but its primary objective is to generate income for the shareholders. In comparison, statutory fund has an underlying objective of serving the policyholders, depicted as profit and loss account of the life insurer.

5.1 **Industry Dynamics:** The process for IFS rating of the life insurers builds on PACRA's understanding of the life/*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. Herein, significant emphasis is placed on Porter's five forces model and its application to local industry dynamics. 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.

5.1.1 **Economic Risk:** While analyzing economy, PACRA evaluates economic policies, GDP growth, performance of important sectors in the economy and potential credit demand. An important part of economic analysis is positioning of industry and impact assessment of economic risk factors on the industry.

5.2 Relative Position: Relative position reflects the standing of the life 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.

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.*

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.*

Franchise: *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.*

5.3 Persistency: One of the measures to gauge the brand loyalty, market perception and reputation of the life insurer is to see the retention rate. Life insurance is generally believed to be a long tail business unlike general insurance; therefore continuation of the premium is fundamental to life insurance business. An insurer incurs a lot of upfront cost for the acquisition of the business in view of its long term retention. Persistency is important from many perspectives. While persistency implies profitability, it reflects that the client is satisfied with the product and the product provider on an overall basis. This, in turn, is a booster for further generation of business. While first year persistency is a healthy sign, the second year and beyond persistency provides assurance as to the sustainability of premium inflow to the insurer. PACRA considers those insurers having excellent ability which are capable of replicating largely the same premium in the succeeding years as in the first year.

5.4 Revenues: In measuring earning's quality of an entity, diversification and stability are very important factors. An entity with a diverse product slate with more than one revenue streams is considered better than an entity with a concentrated earning profile. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which an entity serve s forms a part of the assessment. Stability is measured through historical trend analysis of the entity's revenues.

5.4.1 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 across the operations of the insurer. This entails diversification in the distribution channels, premium mix, product line, client base and geographic spread.

Distribution: *Distribution is the way by which an insurer reaches out to its clients. The strength (or weakness) of distribution directly affects the business prospects of the insurer and hence its ability to repay policyholders. Diversity of distribution channels, the extent of their contribution towards the premium base and insurer's ability to exercise control on these channels are some of the important things to evaluate. Diversity in the channels is desirable as it minimizes the insurer's dependence on any specific channel and reduces the risk of sudden disruption in business. Diversity is important as it provides flexibility in aligning the company's products to the needs of a specific segment of clients. After diversity, the next step is to look at the significance of each distribution channel. By significance, we mean the extent of premium being contributed by each channel. This would help differentiate critical channels from namesake channels. For rating purpose, it is worthy only to look at the critical channels. Business acquisition cost, which is an important consideration from profitability perspective, is also an offshoot of distribution framework of the insurer.*

Premium Mix: *The bloodline for the insurer is the premium it generates. The premium comes to the insurer in various forms and shapes, mainly determined by the type of policy being bought by the client. The policies may be classified from purely risk protection to purely saving schemes. The former mainly specifies the risk that these are covering while the latter represent investments much similar to the products of asset management companies. In between both extremes, there is a range of products which blend characteristics of both types, such as whole life, universal life and endowment. In Pakistan, the predominant nature of products belongs to the mid category, with the element of saving going up in the wake of rising demand for unit linked policies. Life insurance policies may also be classified according to the type of clients these serve: individual or group. Individual policies, sold to individuals, are viewed more favorably because these represent relatively higher stability and persistency. Group policies, covering a group of people, are usually term based and normally reflect a higher risk of claims and cessation. With reference to term, life insurance policies may be classified into permanent or temporary. Permanent policies remain effective until the death of the policyholder or the occurrence of the insured event. In Pakistan, permanent policies are predominantly represented by endowment. Endowment, apart from the risk coverage during the active period of the policy, has a cash value and therefore provides sum-assured to the policy holder at the maturity of the policy. Policyholders have the option to surrender such policies prior to the maturity and avail the cash value at that time. The insurer remains exposed to the risk of occurrence of the insured event prior to maturity till the time the cash values of these policies are short of related sum assured. Permanent policies may have a single premium mechanism, whereby premium comes to the insurer in one go or represent a regular stream of premium to the company over the life of the policy. While the regular premium policies provide the advantage of stable source of revenue, the single premium policies cushion the risk of high payouts due to occurrence of insured event prior to the accumulation of cash values. While evaluating the premium mix, although a high value is placed on individual regular premium policies, those insurers are viewed more favorably which develop an optimum mix of different type of policies, supplementing each other due to the related attached advantages.*

5.5 Profitability: The operations of a life insurer operator are a combination of two activities: underwriting and investments. Underwriting represents the premium for the risk coverage of the policy holder. This premium is also invested; yet the objective is to enable the insurer to meet the claims when they arise. The policy holder *per se* does not have a right to the returns that the insurer generates on this investment. Conversely, takaful, being an Islamic mode, provides a right to the *takaful* holders to the residual amount. Investments are the amounts which have been given to the insurer to invest and make returns for respective policy holders. The accumulated balance of these investments, minus the insurer fee or commission depending upon the product, essentially belongs to the policyholder. The clarity as to these functions is important as the insurer is exposed to different risks with reference to each type of activity. While the underwriting exposes the insurer to the risk of occurrence of insured event, terminating into a payout of claim, the investments are only a matter of fee/commission income and spread of entry/exit depending upon the product profile. Therefore, PACRA believes that both lines of business should be independently evaluated. Takaful operators, being latest entrant into the market, are alive to this distinction; their information management and disclosure practices allow independent analysis of both lines. As the industry grows and the competitive environment captures the different dimension of the life insurance business, PACRA expects that the data and information management and related disclosures would reach – indeed bypass – the benchmark currently set by the family *takaful* operators.

5.5.1 The surplus or deficit in the revenue account is impacted by various line items, which warrant independent analysis, including claims and management expenses. Another critical item is actuarial valuation, which underlie the insurer's estimation as to the liabilities arising in the future. PACRA assesses the quality of the actuarial framework deployed by the insurer. For an in-house actuarial function, the educational and experience profile of the human resource, quality and extent of actuarial working and reports and the challenge which these are put to are some of the essential elements for the assessment in this regard. For external actuaries, the reputation and franchise value of the firm come into play. The objective is to form an opinion that the liabilities are not underestimated to achieve performance related milestones.

5.6 Investment Performance: The business model of insurance involves management of insurance float generated from the premium. This float is invested to make returns. The efficacy of the infrastructure deployed to manage investments can only be gauged through evaluating the comparability of returns and consistency therein. For premium related to pure investments, the insurer is further exposed to the risk of redemption if competitive performance is not delivered. This is judged through the movement of unit price, as investments normally represent unit linked policies in Pakistan. The performance of operator's own investments is compared against the performance of funds maintained for the benefit of the policyholders.

Quality of Investment Book: *Quality of investment Book is gauged through analysis of the investments from risk viewpoint: credit, market and liquid risks are the prime ones. Low rated investments are risky, highly volatile and illiquid investments are risky. 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.*

Investment Income Contribution: *Investment income is the alternative revenue stream. It supplements a company'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 company 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.

5.7 Sustainability: Earning prospects are also monitored, based on budgets and forecast prepared by the NBFC. 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.

Information Required

- *The company's medium-term business plan*
- *Financial projections for next two years*
- *Actuarial valuation report*
- *Annual financial condition report*
- *The company's medium-term business plan*
- *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*
- *Amounts pertaining to disputed claims*
- *Total sum insured consolidated and for each category separately, and the net share of the company after reinsurance.*
- *Break-up of investment book of the company*

6. FINANCIAL RISK

- *Claim Efficiency*
- *Re-Insurance*
- *Liquidity*
- *Capital Adequacy*

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

6.1 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 life 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.

6.2 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.

The major market for life insurance operators is individuals. This implies that the absolute size of per risk exposure is bound not to exceed a certain limit except for few high profile policyholders. It is therefore expected that cession levels would be on the lower side in the local market with less reliance on the re-insurers.

6.3 Liquidity: The liquidity profile of the insurer is the ultimate cover that the company has against claims. The life insurer operator may carry multiple shields against the claims. The first shield being the operational cash flows coming in the form of premium/contribution 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.

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.*

6.4 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. Capital, represented through the shareholder's fund, is essentially the support function in the life insurance/family *takaful* business. 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 have an entirely different capital requirement as against a company following a conservative business model. Nonetheless, the capital would remain the primary source of energy for both types of companies. While computing and analyzing the capital, PACRA considers the regulatory regime applicable to the life insurer/family *takaful* operators, and their internal models, if any, for judging the adequacy of capital.

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.

Credit Enhancement: *The entity 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

- *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.*
- *Statutory returns submitted to SECP*
- *Break-up of premium: pure insurance premium and investment*

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.

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-	**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.
B+ B B-	**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.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	**Distressed.** Extremely weak capacity with limited liquid assets to meet policyholders and contractual obligations, or subjected to some form of regulatory intervention and 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, 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. 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.