The Pakistan Credit Rating Agency Limited

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

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

June 2017

1. INTRODUCTION

- Growth stage of life and family *takaful* business
- Documentation of understanding
- Rating specific to policyholders obligations

1.1 The private sector was allowed to enter the life insurance market in the early 90s. However, over the past couple of years, the private sector has grown significantly with consequent dilution in the market share of the sole government sponsored life insurer – State Life Corporation (~ 51 percent at end-Dec16). It compares favorably with the Indian market where the state owned life insurer – Life Insurance Corporation controls ~71% 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 industry's 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 including windows, are also strengthening their foothold in the market. The business model, though having intrinsic strengths, may take a longer period depending upon the extent of emerging competition.

1.2 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].

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

1.4 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 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.

1.5 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

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

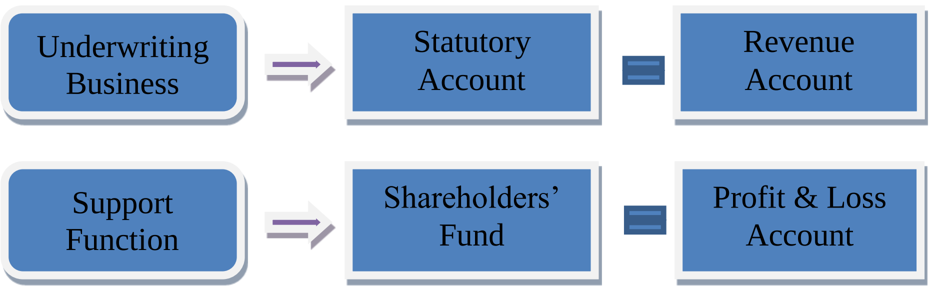
considered, there is no difference between life insurance companies and family *takaful* operators. The latter would be employing Islamic principles for the structure of the business; however the efficacy of these principles and the operators' adherence to them would remain the prerogative of the *shari'ah* 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.

2. BUSINESS RISK

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

2.1 The objective of business risk analysis it to establish the company's ability to sustain – indeed – grow its relative positioning in the industry while ensuring profitable operations.

2.2 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.



2.3 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.

2.4 **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 as a sector study. 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 mitigant's against those risks and taken due measures to meet the challenges. At the same time, we identify the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view on the industry alone, independent of the market players. This exercise helps PACRA to form a view on industry's significance in the economic environment of the country, its attractiveness to entrepreneurs, barriers to entry and the power of suppliers and customers.

[2] Shareholders' Fund is the fund created through the equity contribution of the shareholder. Statutory Fund is the fund consisting of the liabilities towards the policyholders. Both funds have distinct objectives and are accounted for separately.

2.5 Market Position: Market 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.

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

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

2.5.3 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 IFS rating of the insurer.

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

2.6 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 client retention. 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.

2.7 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.

2.7.1 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.

2.7.2 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 a optimum mix of different type of policies, supplementing each other due to the related attached advantages.

2.8 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 business model of insurance involves management of insurance float generated from the premium. This float is invested to make returns. 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.

2.8.1 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 acturial 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.

2.9 Investment Performance: 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 as per the investment philosophy and also peer mutual funds. This is done with a view to negate any bias in the investment decision making process, given inherent conflict of interest.

3. FINANCIAL RISK

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

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

3.2 Claims Efficiency: The underlying risk that the insurer financial strength rating covers is the risk of claims not being met by the insurer. Timely and accurate repayment of claims carries utmost importance in the rating methodology. Claims efficiency represents the pattern in which claims are being settled by the 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.

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

3.3.1 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.

3.4 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.

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

3.6 Capital Adequacy: At the heart of PACRA's financial risk assessment lies the adequacy of the capital for the insurer's business. Capital is pivotal for organizational sustainability, growth drive and as a last cushion against adverse circumstances. 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 a 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.

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

4. QUALITATIVE ASSESSMENT

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

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

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

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

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

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

5. SPONSORS' SUPPORT

- Ongoing support vs. extraordinary support

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

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

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

INFORMATION REQUIREMENT FOR IFS RATING

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

A. BUSINESS RISK

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

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

B. FINANCIAL RISK

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

C. GOVERNANCE

- Profile of the Board of Directors.
- Minutes of the BoD meetings.

D. MANAGEMENT

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

E. CONTROL ENVIRONMENT

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

F. SPONSORS

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