JCR-VIS

GENERAL TAKAFUL

Rating Methodology

The development of Takaful is considered to be vital to the proliferation of Islamic modes of finance, especially since it is now regarded as a viable alternative to conventional insurance. Takaful, as we know it today, dates back to 1979 when the first such company was set up in Sudan. The global Takaful market is estimated at $4 billion today vis-à-vis the conventional insurance market of $3.7 trillion. As Shari'a scholars are increasingly looking to utilize Takaful capacity to indemnify risks that have in the past utilized conventional insurance, there exists an intrinsic demand for larger capacities and a natural growth phenomenon may be witnessed along with the growth in Islamic banking.

Shari'a compliant modes of insurance have recently started to take root in Pakistan, with the only permissible mode of operations being the Wakala Waqf model. The development of this model and subsequent promulgation of Takaful Rules 2005 enabled the first general takaful company to initiate operations in late 2005.

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Akin to conventional insurance, an Insurer Financial Strength (IFS) rating is an assessment of a company's capacity to meet its contractual obligations that mainly constitute claims on insurance policies. When applied to a Takaful firm, the key philosophy behind the rating methodology remains same in so far as the capacity to meet policyholder obligations is concerned.

The rating assessment will incorporate intrinsic traits such as the competency and experience of the management team, the level of capitalization and quality of re-takaful arrangements. In addition, it will consider external factors such as the regulatory framework and the degree of competition within the industry. Where differences between conventional insurance and Takaful impact the claim paying ability of a company, these are highlighted with greater emphasis in this methodology .

What is Takaful?

Takaful is a Shariah compliant arrangement whereby individuals in the community jointly guarantee themselves against future losses or damages. There are two main models of Takaful, namely:

1. Wakala Model
2. Modaraba Model

A third model is a hybrid of the aforementioned Wakala and Modaraba structures. In each kind of Takaful structure, the main constituents are the participants, the Participants Takaful Fund (PTF) and the Takaful Operator. The PTF and Shareholders Fund (SHF) are organized as independent funds.

In analyzing the financial strength of a Takaful company, it is important to view the operator and the fund as individual components as well as on a combined basis. This tiered analysis is undertaken to ensure that sources of the Takaful firm's strengths and weaknesses are fully understood. For start up companies, particular focus is placed upon the business plan, quality of the management team and internal control infrastructure. For any company, JCR-VIS would be reviewing performance relative to the company's own strategic and financial objectives and also vis-à-vis the developments on an industry wide basis.

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Management and Control

The competency and skillset of the management team is crucial to the rating of a Takaful operator. Although the rating does not comment on the degree of compliance of the Takaful operator with religious law, a management team that is well versed with both the principles of Shari'a as well as the fundamentals of insurance will be considered a positive rating factor. Furthermore, JCR-VIS places significant emphasis on non-financial risks in an Islamic Financial Institution (IFI), such as a Takaful operator being perceived as non-Shari'a compliant. In their capacity as modarib or wakeel, a question on integrity of managers may have implications on franchise value, viability & sustainability. This in turn means that Shari'a compliance encompassing, but not limited to all principles of corporate governance will have a distinct bearing on ratings.

The presence of a qualified Shari'a Board is considered as an additional layer of governance in an IFI. The profile of the members of the Shari'a Board is considered both in terms of their competence in their own field and familiarity with present day commercial transactions. The Shari'a board is meant to operate independently of the Board of Directors, which is responsible for providing the organization with strategic direction and maintaining oversight of operations.

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Also, as per the Takaful Rules, each company is required to undergo a Shari'a Audit in addition to a statutory audit. The findings of both these exercises would be given due consideration.

There are also wider issues concerning corporate governance such as any principle-agent issues that may arise. For a Takaful business, there may be heightened "principal-agent" challenges if the Takaful operator does not suffer the negative consequences of poor underwriting. This depends on the kind of model adopted, with the prevelant relationship locally being that of a wakala between the takaful operator and the PTF and underwriting risk borne solely by the participants. The interests of the participants and the takaful operator may be more closely aligned in a modaraba relationship. Additionally, a company may be able to enhance commitment of the executive management by giving them a share in the profits of the company or a portion of the Wakala fees.

Akin to Islamic banking where JCR-VIS views the management as ‘modarib’, we also appreciate the relationship of the management with the participants, in either its role as modarib or wakeel. We believe that it is important for the promotion of corporate governance, transparency and market discipline that a separate exercise for ‘Management Quality Ratings’ is undertaken for the Takaful operator.

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Capitalization

The regulatory framework for Takaful companies calls for separation of SHF from the PTF. Accordingly, the analysis begins by determining the adequacy of contributions relative to the volatility and level of claims. The scope however extends to a firm wide assessment of capitalization on account of the fact that participants have recourse to the shareholders’ fund in the form of Qard-e-hasna.

As per the local regulatory framework, when the PTF including the reserves are insufficient to meet the current payments less receipts, the deficit shall be funded by way of an interest-free loan (qard-e-hasna) from the SHF. It is however pertinent to note that the liability of the shareholders in this regard will not exceed the SHF and the calculation of deficit is undertaken from a cash-flow perspective rather than an accounting loss.

A SHF with greater financial strength than the PTF will serve to enhance the capitalization assessment on a firm-wide basis. On the contrary, the PTF is ring-fenced and weak financial strength of the SHF will not reduce the claims paying ability of the PTF.

The qard-e-hasna ranks subordinated to the benefits (claims) to be received by the participants. Regulations are however silent on the treatment of this loan in case of winding up of a company.

Unlike conventional insurance, any surplus generated within the PTF is shared with the participants, which may prevent capital formation. Past experience as regards the underwriting quality and policy with respect to creation of surplus equalization reserve is considered very important in terms of future assessment of claims paying ability. This reserve would only gradually grow upon time, depending upon the policy adopted by the Takaful operator and any credit thereof is built accordingly into ratings.

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In view of the practice of distributing surplus, the claims paying ability strictly from the PTF perspective may actually vary significantly from year-to-year and undertaking a firm-wide capitalization analysis is therefore considered more appropriate. JCR-VIS also considers the extent of ring-fencing amongst the surpluses generated by various products and the degree to which surplus from one may be used to off-set the losses on others. A more rigid structure may result in a greater need to call for capital from the SHF. Leverage ratios, both operating and financial, are analyzed on a consolidated basis for the firm.

Liquidity

Given the uncertainty associated with the liabilities of a general

Takaful company, the presence of adequate liquid assets on the balance sheet is an important rating factor. As is the case with conventional insurance companies, a Takaful company will have two sources of liquidity. First and foremost are the operating cash flows of a company including re-takaful arrangements. The investment portfolio is considered a secondary source of cash flows, which may be liquidated, if required.

As Takaful companies are obligated to invest only in Shari'a compliant assets, it limits the universe of investable assets. The degree of resilience of the Takaful industry may also be a function of the development of the capital markets. Islamic capital markets are presently limited in scope. Conventionally, debt markets are much bigger than equity markets. However, with a sukuk market that is still young, Takaful companies may end up over-exposing themselves to equities. This has important implications for the overall risk profile of any Takaful operator.

With particular reference to a Takaful company, the liquidity position will need to be analyzed both from the perspective of the Takaful fund itself as well as the company as a whole. The investment portfolio would be analyzed to determine sensitivity to market changes. JCR-VIS will not just assess the liquidity of the portfolio assets but concentration in terms of exposure, credit worthiness of counterparties and any impairment in the portfolio. A diversified investment portfolio can enable a company to better withstand deterioration in a single asset class.

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Re-insurance

Re-insurance, or re-takaful arrangements, are of fundamental significance in assessing the financial strength of an insurance company. JCR-VIS will closely examine the strength of relationship with the re-Takaful operator, the financial standing of re-takaful companies on the panel as well as the terms of re-takaful treaties.

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While there are over 250 Takaful companies in the world today, the number of re-takaful operators is much less. A scarcity of suitable (Islamic-compliant) re-insurers can have implications for financial strength ratings where it exposes a company to concentration related risks or where adequate treaty limits may not be available, either restricting the size of business that may be written or forcing the company to retain greater risk on net account. Regulations & Shari'a scholars in Pakistan however allow Takaful operators to seek re-insurance support from conventional re-insurers (in which case, cession to Pakistan Re-insurance Company Limited becomes mandatory; otherwise it is not applicable to Takaful companies). The strength of re-insurance arrangements would be evaluated on a case by case basis.

Profitability

The profitability analysis of a Takaful company is broken down into two parts, with the primary analysis conducted at the PTF level while a supplementary analysis is also undertaken for the SHF. Profitability is a function of underwriting and investment strategy. The choice of business segment, geographical outreach and diversification of underwritten risks are the key determinants of claim incidence, operating expenditure as well as the company's cash cycle.

JCR-VIS will note the agreed fees or split of profits between the Takaful fund and operator. This is because neither fund is meant to generate excessive profits, at the expense of the other party. The principal operational model for insurance risk management is based on the Islamic concept of wakala. In this respect, the operator's ability to re-negotiate wakala fees is considered important.

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Other Factors

While the number of Takaful operators is fast increasing, they may yet be faced by greater challenges given their short operational histories and strong competition from conventional insurers who have achieved economies of scale over time. Furthermore, regulatory framework may also evolve further. Ratings will be mindful of developments in the regulatory framework and other changes in the external environment **JCR-VIS**

Note:

Other relevant papers available at www.jcrvis.com.pk/resource.aspx

General Insurance published in November 2003;

Mutual Funds - Rating Methodology published in December 2006

Key Ratios

Operating Leverage:

(Premium Written % Adjusted Shareholders Fund)

To be calculated for the entity on a consolidated basis.

Financial Leverage:

(Technical Reserves % Adjusted Shareholders Fund)

To be calculated for the entity on a consolidated basis.

Insurance Debt % Gross Premium:

To be calculated for PTF only.

Insurance Debt % Adjusted Total Assets:

To be calculated independently for PTF and also on a combined basis for PTF & SHF.

Operating Cash % Cash Premium Written:

To be calculated independently for PTF and also on a combined basis for PTF & SHF.

Gross Claims Ratio:

To be calculated for PTF only.

Net Claims Ratio:

To be calculated for PTF only.

Underwriting Expense Ratio:

(Wakala fees + direct expenses) % premium earned.

Combined ratio:

(Net Claims Ratio + Underwriting Expense Ratio)

To be calculated for PTF only.

Net Operating Ratio:

To be calculated for PTF only.

Efficiency Ratio for SHF:

Operating expenses % total revenues less financial expenses.

GENERAL TAKAFUL RATING SCALE

AAA
Highest capacity to meet policyholder and contract obligations. Risk factors are negligible.

AA+, AA, AA-
Very high capacity to meet policyholder and contract obligations. However, risk is modest, but may vary slightly over time due to business/economic conditions.

A+, A, A-
High capacity to meet policyholder and contract obligations. Risk factors may vary over time due to business/economic conditions.

BBB+, BBB, BBB-
Adequate capacity to meet policyholder and contract obligations. Risk factors are considered variable over time due to business/economic conditions.

BB+, BB, BB-
Marginal capacity to meet policyholder and contract obligations. Risk factors may vary widely with changes in business/economic conditions.

B+, B, B-
Low capacity to meet policyholder and contract obligations. Risk factors are capable of fluctuating widely with changes in business/economic conditions.

CCC
Very low capacity to meet policyholder and contract obligations. Risk may be substantial.

CC
Weak capacity to meet policyholder and contract obligations. Risk may be high.

C
Very weak capacity to meet policyholder and contract obligations. Risk may be very high

D
Extremely weak capacity to meet policyholder and contract obligations. Risk is extremely high.

Rating Watch
JCR-VIS places entities and issues on ‘Rating Watch’ when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). A ‘Rating Watch’ announcement means that the status of the assigned rating(s) is uncertain and an event or deviation from an expected trend has occurred or is expected and additional information is necessary to take a rating action. JCR-VIS also designates direction, Positive, Negative or Developing, to ratings placed under ‘Rating Watch’. This shows JCR-VIS’ opinion regarding the likely direction of a rating placed under the Rating Watch status. Developments in factors other than those that necessitated the ‘Rating Watch’ may result in a rating change, while the rating(s) continues to be under ‘Rating Watch’.

Rating Outlooks
The three outlooks ‘Positive’, ‘Stable’ and ‘Negative’ qualify the potential direction of the assigned rating. An outlook is not necessarily a precursor of a rating change.

Suspension
In the event that JCR-VIS deems that, as a result of lack of cooperation with regard to the provision of information or for any other reason it is not possible to assess the current status of the assigned rating, the rating will be suspended.

‘p’ Rating
A ‘p’ rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A ‘p’ rating is shown with a ‘p’ subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings.

Withdrawal:
A rating is withdrawn in the following situations:
a) Non-renewal/ cancellation of the rating agreement; and
b) Cessation of an entity for any reason.

Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copyrighted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.

Syed Ziauddin Ahmed
Advisor

Syed Ziauddin Ahmed has worked in senior positions in the insurance industry for over 35 years. Prior to joining JCR-VIS in July 2005, he had worked as CFO of the largest insurance company of Pakistan for more than 23 years. Mr. Ahmed is a Fellow member of the Institute of Chartered Accountants of Pakistan.

Sobia Maqbool
Senior Manager

Sobia Maqbool leads ratings of Financial Instiutions. She holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi in 2003.

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Naveen Hasan has been involved in the analysis of Financial Institutions. She holds a Bachelors degree in Business Administration from The Institute of Business Administration.

Jahangir Kothari Parade (Lady LLoyd Pier)
Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.


Jahangir Kothari Parade

National Excellence, International Reach

JCR-VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, JCR-VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, JCR-VIS continues its endeavor to remain an emblem of trust.

JCR-VIS Credit Rating Company Limited

Affiliate of Japan Credit Rating Agency, Ltd.
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