VIS

Credit Rating Company Limited.

CRITERIA FOR GENERAL INSURANCE RATING

Table of Contents

SUMMARY OF CRITERIA CHANGES

In this updated methodology, environmental, social, and governance (ESG) considerations have been integrated to align with current assessment standards.

SCOPE OF CRITERIA

The criteria 'Insurer Financial Strength (IFS) Rating Methodology' applies to a range of entities operating in the insurance sector conducted by VIS Credit Rating Company Limited (VIS). An IFS rating is an assessment of an insurance company's capacity to meet its contractual obligations that mainly constitutes of claims on insurance policies. However, timeliness of these payments is not commented on as is the case in conventional corporate credit ratings. The level of risk faced by an insurer is a function of the implicit and explicit risks associated with the business being underwritten. An IFS rating is defined as an evaluation of the company's ability to bear the associated risks which are reflected in the strength of its cash flows, liquidity reserves, access to credit or capital and most importantly, strength of its reinsurance arrangements.

As per VIS' general insurance methodology, insurance industry is subdivided into three segments based on their Relative Market Shares (RMS); large, having RMS above 3.0x of 3-year trailing average industry premium, medium sized having a share between 0.75x and 3.0x and small, having RMS of below 0.75x. Each segment has well defined benchmarks, against which a company is analyzed.

SUMMARY OF CRITERIA CHANGES

This criteria is based on the fundamentals used in the last updated criteria documents. The fundamental criteria as outlined in 'Rating Methodology – General Insurance' dated November 2019 remains the same with no changes to the ratings framework itself. This document aims to lay out in more detail the key areas of assessment when reviewing IFS ratings and provides additional guidance on the relevant factors within the existing framework.

In line with various changes in the local insurance industry over the past several years and the international guidelines, VIS has modified the Rating Scale for Insurer Financial Strength (IFS) Rating. The IFS rating scale is revised to create a clear distinction in symbols of IFS Ratings against Credit Ratings as well as to address any ambiguity with respect to rating category. For greater clarity, rating definitions have also been modified.

AN OVERVIEW OF RATINGS FRAMEWORK

The goal is to allow each stakeholder to know in detail, each of the major rating drivers and ultimately what factors may change the ratings in the future. VIS analyses both the intrinsic fundamental characteristics of the insurer along with the environment in which the company operates. The existing legal and regulatory environment, the number and size of the players operating in the market, extent of technological advancement and the entry and exit barriers in effect, have a bearing on the opportunities that the company can capitalize upon, and also threats that it may encounter.

Along with the macroeconomic view of the industry, company specific analysis based a combination of qualitative and quantitative factors is also conducted. Qualitative factors such as management expertise and internal controls are considered; as per methodology, these factors play a vital role in forming a healthy financial position. Furthermore, ownership structure, business and corporate strategies and vision that drives the institution, are important determinants of an entity's prospects.

Finally, ratings take into account the external support available to the entity and may be enhanced on the basis of the extent of support from sponsors / shareholders, associated companies etc. and the relative standing of the supporting entity.

Key factors that are considered in assessing financial strength of an insurance company include:

Industry Risk Profile

- Political Risk
- Economic Risk
- Financial System Risk
- Market Growth Aspects
- Regulatory Regimes

Competitive Position

- Relative Market Share
- Product Suites
- Depth of Marketing Channels
- Geographical Diversity

Financial Risk Profile

- Capital Strength
- Underwriting Exposure
- Investment Portfolio
- Quality of Underwriting
- Claims Management
- Reinsurer Strength

Organizational Risk Management

- Compliance with Exposure Policies
- Impact of Exposures on Capitalization and Liquidity
- Financial System Risk
- Per Party Exposure Limit
- Soundness of Reinsurance Arrangements

Liquidity Position

- Relative Strength of Solvency Ratio
- Assessment of Liquid Assets

Corporate Governance & Management Evaluation

- Quality of Board
- Management Team
- Board Effectiveness & Independence
- Organizational Complexity

RATING METHODOLOGY

Our assessment model is based on some key factors, qualitative and quantitative, which may further be broken-down into sub-factors to comprehensively capture the rating drivers.

BUSINESS RISK SUB-FACTORS
Industry Risk
Management & Organization Profile
Operational Risk

A. QUALITATIVE ELEMENTS

Industry risk along with operational risk and management & organizational profile of a specific company determines mainly the business risk of an entity. The business risk of a company to a large extent is dependent on financial performance over the years and the premium pricing power the insurance company enjoys in the market.

A. (i) Board and Management

The strength of the sponsors and composition of the board and its committees are important features of a sound business. The profile of the board members and their experience in the insurance industry is of a considerable advantage, and may be gauged through their contribution to the company in terms of providing it with a vision and becoming the main source of business strategy. VIS also considers management quality and organizational structure as a key element in the rating process since it is critical to the overall performance of a company. The primary purpose of these factors is to understand how the board's vision and strategy is translated into daily operations. Team experience and competence, corporate structure and decision-making hierarchy are also considered. A good management develops the company's competitive position and manages resources in a prudent manner. Vision, objectives and strategies, are viewed in relation to the existing macro environment. Evaluation of the management's strategies, operations, efficiencies and risk tolerance, as well as an insurer's competitive advantage in the marketplace will influence our opinion of future financial performance. Our analysis also considers whether vision cascades down to lower management, ensuring a high level of commitment. Details regarding succession planning are also taken into account to evaluate the extent of stability in the management hierarchy.

A. (ii) Controls and Risk Management

Insurance companies are normally exposed to a large number of risks; the exact quantum of which is not known at the inception of a policy. As such, it is vital for these companies to develop strong risk management systems, which can help identify concentration levels and assist in mitigating the risk of extraordinary losses. Internal audit systems should be comprehensive and reliable. Risk management involves diversifying sector exposures, minimizing single event risks and identifying recurrent loss areas. Management Information System (MIS) needs to be robust enabling the company to undertake scenario testing. While evaluating MIS, the extent of networking between branches, which may enable ready and immediate access to branch data, and the level of data backup and security are also taken into consideration. Diversification of risks is considered to be a primary source of risk mitigation. Larger companies that demonstrate a spread of business in terms of business lines or geographic dispersion are less exposed to risks associated with particular types of exposures. The company's presence in different geographical areas, branch and agent network and its marketing strategy are also viewed to identify its growth potential. In captive insurance companies the evaluation of concentration related risks becomes even more important. In Pakistan, where not many large, diversified conglomerates are present; small companies are often exposed to greater sectoral concentration. Controls also involve the systems in place for managing the distribution channels. Quality of agreement with insurance agents, the checks and constraints imposed on the agents' business and timely monitoring of the same are important.

The general insurance sector, pivotal in providing protection against diverse risks, is seeing a growing emphasis on ESG integration. Environmentally, insurance companies are increasingly evaluating the sustainability practices of their policyholders, considering factors like environmental risk management and carbon footprints, especially when underwriting policies for businesses.

Socially, insurers are becoming more attentive to the societal implications of their products, ensuring they promote fairness, inclusivity, and do not inadvertently support harmful practices. Governance, with its focus on transparency, ethical behavior, and stakeholder engagement, is taking center stage, ensuring that insurance companies maintain the trust of their policyholders. By seamlessly integrating these ESG factors into their methodologies, general insurers can better anticipate emerging risks, align with stakeholder expectations, and contribute to a more sustainable and resilient society.

B. QUANTITATIVE ELEMENTS

An insurance company's ability to withstand shocks is usually affected by its market reach and the spread of business. Development of efficient internal systems and depth in management also requires an adequate resource base. Smaller companies are generally exposed to higher concentration risks emanating from a weak reinsurance arrangements and corresponding higher internal risk retention. These companies face greater competitive pressures and may not have easy access to external capital and liquidity support. These factors, if found to be present, will typically tend to constrain ratings. Individually, primary quantitative drivers of IFS ratings and key benchmarks for the same have been discussed below as part of this rating methodology.

B. (i) Capitalization

Strong capitalization enables an insurer to better withstand large underwriting losses and minimize impact of volatility in investment income while also allowing management to take advantage of growth opportunities in the market. While the Insurance Ordinance 2000 has set minimum capital requirements (MCR) for insurance companies, meeting the MCR alone does not necessarily imply sufficient capital. Adequacy of capital is evaluated in the context of the segment-wise exposures and the historical loss trends in these segments. Moreover, VIS analyses the strength of an insurer's capital base through various leverage ratios measuring the level of business underwritten and technical reserves against the level of capitalization. The soundness of operating and financial leverage along with quantum of technical reserves and surplus are important rating factors.

While determining the level of capitalization, hidden reserves and impairments are also taken into consideration. Furthermore, composition of technical reserves is evaluated to assess the extent to which these are held against payable claims or unearned premiums. The Insurance Ordinance prescribes creating an additional 'premium deficiency reserve' if a time series analysis shows technical reserves have been insufficient, on an average, to meet losses net of reinsurance recoveries.

IFS rating may be enhanced on the basis of the extent of support from sponsors / shareholders, associated companies, etc. VIS takes into account how important the company is to the group, the relative financial health of the group and any explicit or implicit support to the company being rated. VIS seeks to analyze the particular instances in which assistance was required by the company being rated and the degree of support provided by the sponsors in the past. Evaluation of the financial strength of the group then becomes important to give any benefit in IFS rating including its franchise value, access to funds and diversification element.

B. (ii) Liquidity

A general insurance company's liabilities contain an additional uncertainty factor; both, the timing and the amount of the liability are uncertain imposing additional liquidity requirements. A high level of internal cash generation enables an insurer to meet its need for cash without sale of its investments. The primary source of liquidity is the operating cash flows, while liquidation of the investment portfolio is considered to be a secondary source, necessitated only in the event of extraordinary claims. VIS forms an opinion about the health of the invested asset portfolio in terms of liquidity, impairment if any, concentration of exposure and returns. Quality and liquidity of an insurer's investment portfolio is assessed to determine the level of coverage against its insurance related liabilities. Another key component of this analysis is the solvency margin; regulations have specified guidelines for the admissibility of assets to determine the solvency margin of a company. The solvency ratio is a key metric used to measure the insurer's ability to meet its contractual obligations and it indicates whether a company's cash flow is sufficient to meet its liabilities.

The level of insurance debt is evaluated as an indicator of the insurer's cash cycle and its relationship with, and dependence on its agents, co-insurers and re-insurers. Aging of insurance debt and its overall mix allows for an assessment of the quality and recoverability of these receivables. Lower levels of insurance debt as a proportion of gross premium are considered as indicators of adequate level of liquidity.

Insolvency risk is defined as the risk of loss (or of adverse change) in the financial situation of a company which results from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which a solvency undertaking is exposed, in the form of counterparty default risk, spread risk, or market risk concentration. Insolvency risk of general insurance firms consist of three components. The first is the credit quality of their investment portfolio, whose performance we measure using investment returns. Investment portfolio of insurance companies also remains exposed to market risk. The second is the counterparty risk through reinsurance activity. A high reinsurance ratio increases the credit risk exposure of firms. The third is the direct default risk of insurers when their liabilities are greater than their assets and therefore, they might become insolvent. The financial health of firms is measured using the leverage, profitability, solvency and liquidity ratios. Size, growth and claims volatility are also taken into account.

In the insurance sector, unlike the banking sector, there is no central bank that acts as the lender of last resort. In insolvency situations, there is lack of such liquidity support. In addition, limitations due to cross border transactions with respect to reinsurers together with inefficiencies in the judicial system related to claim processing may lead to liquidity concerns for the insurance companies. VIS believes that lack of depth in the capital markets also constraints timely access to liquidity. All these factors pose a limitation to higher ratings.

B. (iii) Earnings and Franchise Value

Profitability of an insurance company is a function of its 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. Large swings in business segments may indicate a shift towards riskier business lines and may be impelled by liquidity or growth-related objectives. Conversely, a shift in focus may also be motivated by a need to minimize running costs or avoid excessive claim losses. Rapid premium growth, particularly for smaller, less diversified companies may indicate excessive risk undertaken. Sudden increments in premium written during any one year may be motivated by large losses from old policies and need to be monitored closely.

A company's pricing strategy and whether it is in consonance with risks underwritten is also an important element affecting performance over the longer run and in assessing sustainability in earnings. Trends on claims and expenses are also assessed. Segment-wise analysis of claims is carried out to determine each business line's impact on overall profitability. To determine operating efficiency, business generation and operational costs are also evaluated in relation to the premium generated.

Investment income serves to dampen the stress on underwriting streams. Well-diversified and mature insurance companies may sometimes also post underwriting losses, which are offset by returns on the investment portfolio. The quality, diversity and returns of different segments of the investment portfolio are important determinants of investment support to underwriting risk. They are therefore an area of interest, while assigning ratings.

B. (iv) Reinsurance

Reinsurance arrangements are integral to the mitigation of insurance risks. An insurer's relationship with its reinsures and the financial standing of reinsurance companies on its panel are an important consideration in assigning rating. Ratings of reinsurers assist in forming an opinion on their financial strength. Reinsurance treaty terms determine the capacity of an insurer to take risks and changes in terms often indicate an insurer's track record of risk management. There are different kinds of covers provided by a reinsurer. Covers such as surplus, quota or excess of loss are most commonly used. These covers are negotiated for every business segment individually and are based on the company's expectations for losses in these segments. Certain exposures, e.g., terrorism cover, are also being negotiated by the foreign reinsurers and local insurance companies. As a result, dependence on higher rated reinsurers is increasing as the capacity of these reinsurers to meet claims obligations becomes critical. The international ratings of the reinsurers and soundness of negotiated treaties with them have a bearing on assignment of IFS ratings to the local insurers.

The reinsurers' performance is also indicated by the quantum and aging of reinsurance receivables. The extent of impairment is also determined to evaluate stress on liquidity. Timely cash collection is important, especially for smaller insurance companies, which may not have readily available liquidity to meet large losses.

An insurer's retention ratio determines the proportion of risk retained by the company. Ideally, an insurer's own retention should be between 40-60% of gross premium. Unusually high retention levels could signal inadequate reinsurance protection, while low retention could hamper profitability. In companies with excess of loss (XOL) coverage for a significant portion of their business, the retention ratio would tend to be high. The adequacy of this cover can be assessed through a comparison between the treaty's protection level and average claim size over the period of assessment.

GENERAL INSURANCE RATIOS

A. UNDERWRITING

- Gross Claims Ratio: Claims Expense / Premium Earned
- Net Claims Ratio: Net Claims Expense / Net Premium Revenue
- Cession: Reinsurance Ceded / Premium written

B. CAPITALIZATION

- Gross Financial Leverage: Gross Technical Reserves1 / Adjusted Shareholder's Equity2
- Net Financial Leverage: Net Technical Reserves3 / Adjusted Shareholder's Equity
- Operating Leverage: Net Premium Revenue / Adjusted Shareholder's Equity

C. LIQUIDITY

- Insurance Debt to Gross Premium: Insurance Debt4 / Premium Written
- Liquid Assets to Technical Reserves: High Quality Liquid Assets / Net Technical Reserves

- Liquid Assets to Gross Claims Outstanding: High Quality Liquid Assets / Provision for Outstanding Claims
- Net Operating Cash Flow: Cash Flow from Operations + Dividend Income + Rental Income + Recurring Investment Income
- Cash Premium Written: Premium Written – Reinsurance Ceded + Change in Outstanding Premium

D. PROFITABILITY

- Underwriting Profit: Net Premium Revenue – Net Claims – Operating (Management) Expenses (+) /- Net Commission - General and Admin Expenses
- Underwriting Expense Ratio: [Management Expense (+)/- Net Commission + General & Admin Expenses] / Net Premium Revenue
- Combined Ratio: Net Claims Ratio + Underwriting Expense Ratio
- Net Operating Ratio: Combined Ratio - [Recurring Investment Income / Net Premium Revenue]

1. *Provision for Outstanding Claims + Provision for Unearned Income + Commission Income Unearned*
2. *Equity + [unrealized surplus on all investments]*
3. *Gross Technical Reserves - Prepaid Reinsurance Ceded*
4. *Premiums due but unpaid + Amount due from other insurers and reinsurers*

RATING SCALE & DEFINITIONS

Rating scale and Definitions may be accessed at (https://docs.vis.com.pk/docs/VISRatingScales.pdf)

Faheem Ahmad
President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group Chairman,
Vice-Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. 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.

Javed A. Callea - Member
Advisor

Mr. Callea is a professional in the financial sector with over 35 years of experience mostly in the financial institutions with certain exposure to service and infrastructure sectors in Pakistan. He has held the position of Chief Executive of a leasing company for 10 years. His core areas of expertise cover leasing, development financing, project management, investment & merchant banking, strategic investment management and real estate. Major financial institutions he worked for include Pakistan Industrial Credit and Investment Corporation, State Life Insurance Corporation, Bankers Equity, Crescent Leasing Corporation and Saudi Pak Ind. & Agri. Inv. Company. He has also served as Member Finance of Water & Power Development Authority of Pakistan and as member of the Inquiry committee on stock exchange crises in 2000 commissioned by the SECP. He earned his MBA degree from the Institute of Business Administration in 1974.

Maham Qasim
Group Head - Ratings

Maham Qasim has been associated with VIS since August 2014. During the course of her career, she has been involved with assignments in a broad range of sectors including industrial corporates, banking, microfinance, insurance and asset management. Maham has a Master's Degree in Business Administration with majors in Finance and Banking from Lahore School of Economics.

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.

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, VIS is positioned to aim for an international mark. In this regard, the global experience of our international affiliates and partners have 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, VIS continues its endeavour to remain an emblem of trust.

INTERNATIONAL

Affiliates

Islamic International Rating Agency – **Bahrain –** iira.com

Credit Rating Information & Services Ltd. – **Bangladesh –** crislbd.com

Collaborations

Japan Credit Rating Agency, Ltd. - **Japan**

China Chengxin International Credit Rating Company Limited - **China**

CONTACT

Karachi VIS House

128/C, 25th Lane off Khayaban-e-Ittehad,
Phase VII, DHA, Karachi

Tel: (92-21) 35311861-64

Lahore VIS House

431, Block-Q, Commercial Area, Phase-II,
D.H.A. Lahore - Cantt.

Tel: (92-42) 35723411-13

VIS
Credit Rating Company Ltd.

www.vis.com.pk

info@vis.com.pk

DISCLAIMER