March 2022

VIS

RATING METHODOLOGY

Takaful Companies

The development of Takaful is considered to be vital to the proliferation of Islamic modes of insurance, especially since it is regarded as a viable alternative to conventional insurance. 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 coupled with a natural growth phenomenon that may be witnessed as Islamic banking grows. Recent launch of Window Takaful Operations by conventional insurance companies will also aid in developing the Takaful market.

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. Where differences between conventional insurance and Takaful impact the claims paying ability of a company, these are highlighted with greater emphasis in the methodology.

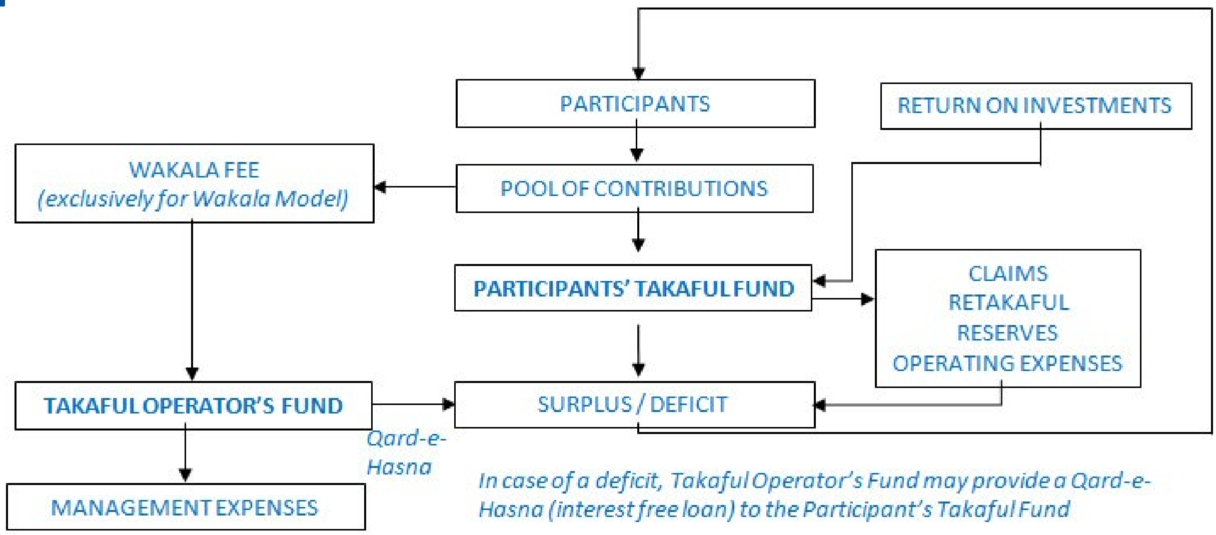
WHAT IS TAKAFUL?

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

Wakala Model	Modaraba Model
Is based on an agency contract	Is based on a profit sharing mechanism
An agency contract is agreed between the participants and operator to conduct the business	A business contract between the participants who provide the fund or capital and operator that manages the business
Operator acts as an agent or "wakil"	Operator acts as a manager or "Modarib"
Operator charges a fee under the agreement for the services its renders.	A profit sharing ratio is decided between the participant and operator
Operator earns its revenue from the agency fee as well as returns on the investment of its shareholders' fund	Profit in takaful includes returns on investments and surplus from underwriting from participants' fund only. It does not include profit posted by the operator itself.

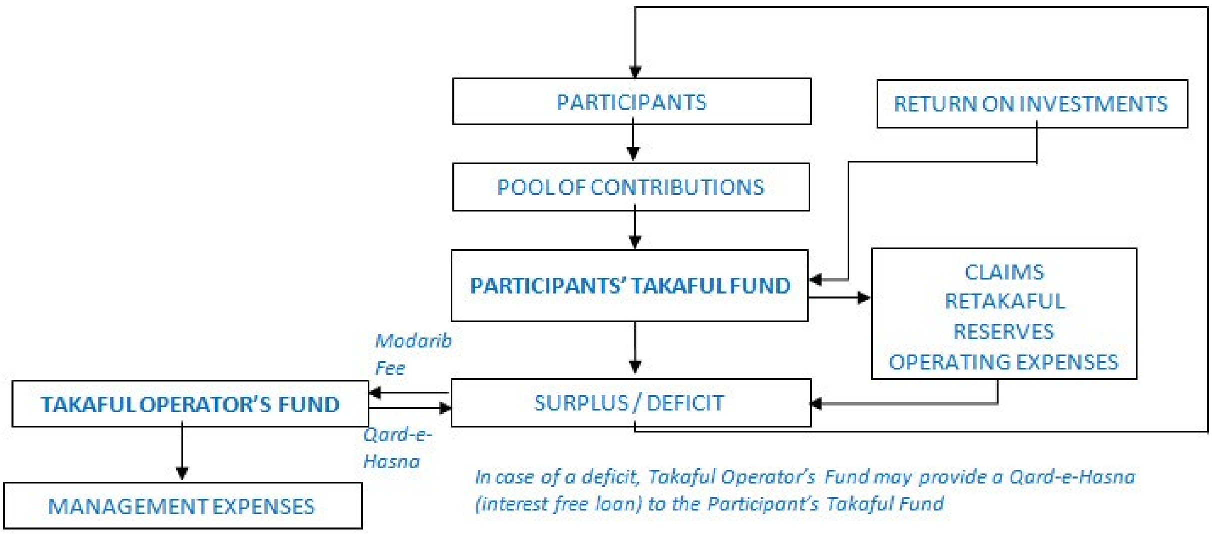
WAKALA MODEL

In the pure Wakala model, the shareholders are absolved of carrying any underwriting or investment risk. In view of this, a pure Wakala model heightens the principal-agent conflict as managers on behalf of shareholders act as wakil for both the underwriting and investment management function. As such, shareholders are entitled to an upfront management fee irrespective of the quality of underwriting operations while all profits/losses accrue solely to the policyholders.



MODARABA MODEL

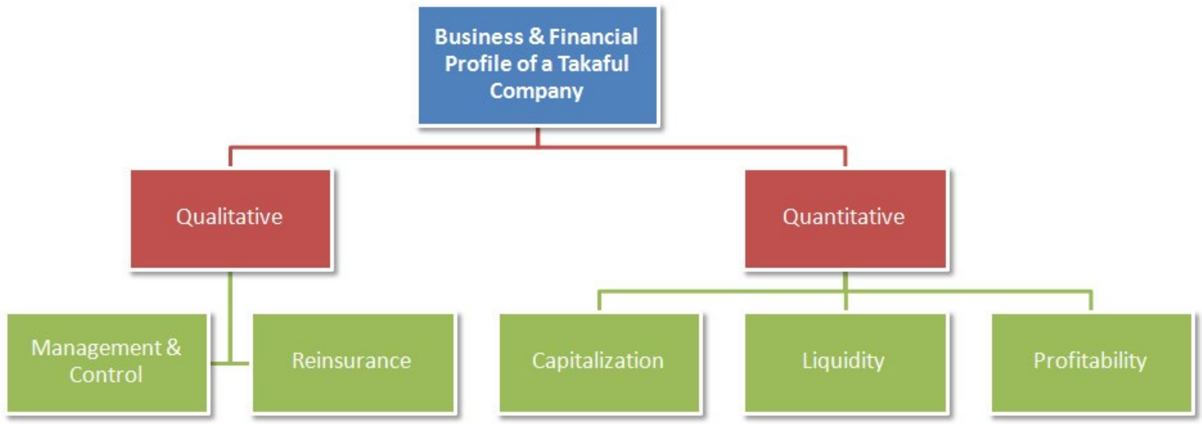
The pure Modaraba model is distinguished by the high degree of accountability and commitment enforced upon the management, acting on behalf of the sponsors of the company. This is because shareholders would only be entitled to a return if the company earns underwriting profits and positive investment income. Losses would be borne entirely by policyholders as capital providers (Rab-ul-maal), in the absence of managerial negligence. The pure Modaraba model closely aligns the interests of both the participants and the management, acting on behalf of the sponsors, as the shareholders are entitled to a share of underwriting profit and investment income. The management is incentivized to improve business performance. In view of this, takaful operators organized under the pure modaraba model are viewed positively, cetrus paribus.



A third model is a hybrid of the 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's (also known as Shareholders') Fund. The PTF and Shareholders' Fund (SHF) are organized as independent funds. The hybrid Wakala Waqf model ranks between the aforementioned models, as the management acts as wakil in its role as the underwriter and as modarib for the investment management function. Accordingly, the SHF is entitled to an upfront Wakala fee, charged as a fixed percentage of gross premiums. SHF is additionally entitled, as the modarib of the PTF's investment portfolio, to a pre-determined share of investment profit accruing to the participants.

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 startup companies, particular focus is placed upon the business plan, the quality of the management team and the internal control infrastructure. The experience of shareholders and the size of shareholders fund on standalone and relative basis to risk underwritten are important rating considerations.

For any company, VIS would be reviewing the company's performance relative to its own strategic and financial objectives and also vis-à-vis the developments on an industry wide basis. The rating assessment will also 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.



MANAGEMENT AND CONTROL

The competency and skills of the management are 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, 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 wakil, a question on integrity of managers may have implications on franchise value, viability & sustainability. This in turn means that Shari'a compliance risk will have a distinct bearing on ratings; in addition compliance with all principles of corporate governance will also be looked at.

The presence of a qualified Shari'a Board is considered as an additional layer of corporate governance in an IFI. The profile of the members of the Shari'a Board is evaluated 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. 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 are given due consideration.

There are also wider issues concerning corporate governance such as any principal-agent issues that may arise. For a Takaful business, there may be heightened "principal-agent" challenges if the Takaful operator does suffer the negative consequences of poor underwriting. This depends on the kind of model adopted, with the more common relationship being that of a wakala between the takaful operator and the PTF resulting in 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 VIS views the management as 'modarib', we also appreciate the relationship of the management with the participants, in either its role as modarib or wakil.

RE-INSURANCE

Re-insurance, or re-takaful arrangements, are of fundamental significance in assessing the financial strength of an insurance company. VIS closely examines 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.

Globally, the number of Takaful companies outpaces the number of re-takaful operators available. As a result, 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.

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.

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 (excluding share of profits) to be received by the participants. Regulations are however silent on the treatment of this loan in case of winding up of a company. In Pakistan, the company is only required to pay Qard-e-Hasna from underwriting surplus. This is considered positively as underwriting surplus is arrived at after taking all claim expenses and associated reinsurance costs/benefits into account.

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.

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. VIS also considers the extent of ring-fencing amongst the surpluses generated by various businesses 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. 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.

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.

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 ability to re-negotiate wakala fees with participants is considered important.

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.

TAKAFUL RATIOS & DEFINITIONS

Operating Leverage (Premium Written % Adjusted Shareholders Fund[1])	*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)*

[1] Shareholders Fund adjusted for revaluation gain/ (loss) on investments

RATING SCALE & DEFINITIONS: INSURER FINANCIAL STRENGTH

AAA(IFS)
Exceptionally Strong. Exceptionally strong capacity to meet policy holders and contract obligations. Risk factors are minimal, and the impact of any adverse business and economic factors is expected to be extremely small.

AA++(IFS), AA+(IFS), AA(IFS)
Very Strong. Very strong capacity to meet policy holders and contract obligations. Risk factors are very low, and the impact of any adverse business and economic factors is expected to be very small.

A++(IFS), A+(IFS), A(IFS)
Strong. Strong capacity to meet policy holders and contract obligations. Risk factors are low, and the impact of any adverse business and economic factors is expected to be small.

BBB++(IFS), BBB+(IFS), BBB(IFS)
Good. Good capacity to meet policyholder and contract obligations. Risk factors are moderate, and the impact of any adverse business and economic factors is expected to be manageable.

BB++(IFS), BB+(IFS), BB(IFS)
Marginal. Marginal capacity to meet policyholders and contract obligations. Though positive factors are present, risk factors are relatively high, and the impact of any adverse business and economic factors is expected to be significant.

B++(IFS), B+(IFS), B(IFS)
Weak. Weak capacity to meet policyholder and contract obligations. Risk factors are high, and the impact of any adverse business and economic factors is expected to be very significant.

CCC(IFS) , CC(IFS), C(IFS)
Very Weak. Very weak capacity to meet policyholder and contract obligations. Risk factors are very high, and the impact of any adverse business and economic factors may lead to insolvency or liquidity impairment.

D(IFS)
Distressed. Extremely weak capacity with limited liquid assets to meet policyholders and contractual obligations, or subjected to some form of regulatory intervention or declared insolvent by the regulator.

Rating Watch: 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). Refer to our 'Criteria for Rating Watch' for details. https://docs.vis.com.pk/docs/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details. https://docs.vis.com.pk/docs/criteria_outlook.pdf

'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. Refer to our 'Policy for Private Ratings' for details. https://docs.vis.com.pk/docs/private_ratings.pdf

Faheem Ahmad

President & CEO, VIS Credit Rating Company Limited
Founder, VIS Group
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. He could be contacted at faheem@vis.com.pk

Maimoon Rasheed

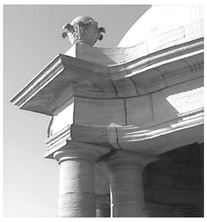
Director

Maimoon possesses 20+ years' experience in financial risk assessment with focus on credit ratings, conventional finance, and general management. He possesses management experience in the fields of financial risk modeling, asset management and brokerage. He has been actively involved in both buy and sell side capital market research. Maimoon's overall experience comprises ratings of entities across a range of sectors including financial – Commercial banks, investment banks, asset management companies, leasing companies, modarabas, securities houses and insurance companies – and corporates in different industries. He obtained his B.S in Applied Geology from Punjab University, Lahore. He also has Masters Degrees in Business Administration with majors in Finance.

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.



National Excellence, International Reach

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 endeavor to remain an emblem of trust.

VIS Credit Rating Company Limited

International Affiliates

Islamic International Rating Agency - **Bahrain**

Credit Rating Information & Services Ltd. - **Bangladesh**

Borhan Credit Rating Company Ltd. - **Iran**

International Collaborations

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

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

KARACHI
VIS House - 128/C, Jami Commercial Street 14
D. H. A. Phase VII, Karachi - Pakistan

LAHORE
VIS House - 431, Block Q Commercial Area
Phase II, DHA, Lahore - Pakistan

Tel: (92-21) 5311861-70 Fax: (92-21) 5311872-73
E-mail: info@vis.com.pk
Website: www.vis.com.pk