

**Rating Agencies Methodologies for Takaful and Re-Takaful Firms**

**By**

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Honorable speakers, distinguished ladies and gentlemen,  
Thank you for letting me have this opportunity to present the Rating Methodology of JCR-VIS for Takaful and Re-takaful Firms. From the set up of the first Takaful operator in Sudan in 1979, 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. My presentation covers the key features of our rating methodology for takaful firms while also highlighting the extent to which it differs from ratings of conventional insurance companies.

Before starting on with the methodology details, I would like to highlight key statistics of the local insurance market. There are about 38 industry participants, with JCR-VIS' clientele of insurance companies including almost 70% of the universe. The spread of ratings is diverse.

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. JCR-VIS rates the entire universe of takaful operators.

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 level of risk borne by an insurer is a function of the type of business being underwritten. An IFS rating entails an evaluation of the company's ability to bear that risk as reflected in the strength of its cash flows, its liquidity reserves, access to credit or capital and most

importantly the strength of its reinsurance arrangements. JCR-VIS analyses both the intrinsic fundamental characteristics of the insurer including competency and experience of the management, along with the environment in which the company operates. I will elaborate on each of these in detail in my presentation.

First turning focus on the business managers, JCR-VIS believes that 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 Shariah as well as the fundamentals of insurance will be considered a positive rating factor. 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 Shariah Board is considered as an additional layer of supervision in an Islamic financial institution.

There are also issues concerning corporate governance such as any principle-agent issues that may arise, depending on the kind of business model adopted. We can begin by distinguishing two primary models, Taawuni and Waqf model, within which there can be two conceptual frameworks, namely, Wakala Model and Modaraba Model. A third model is a hybrid of the aforementioned Wakala and Modaraba structures, referred to as the Wakala Waqf 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*.

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 Wakeel 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.

The hybrid Wakala Waqf model ranks between the aforementioned models, as the management acts as wakeel 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 premium. SHF is additionally entitled, as the mudarib of the PTF's investment portfolio, to a pre-determined share of investment profit accruing to the participants.

These models define the relationship between the shareholders' fund and the participants' fund. IFS rating would take into account the characteristics of the concerned business model and any potential source of conflict. This is because the end objective of an IFS rating, irrespective of the model used, would be to evaluate the claim paying ability of the company as a whole which of course is impacted by the degree of commitment of management to sound underwriting practices and prudent investment management.

The regulatory framework for Takaful companies calls for separation of shareholders' fund from the participants' Takaful fund. 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.

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. 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.

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.

Depending on the business model adopted, 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. JCR-VIS analyses the strength of an insurer's capital through various leverage ratios measuring the level of business written and technical reserves. A dollar of capital supporting more than three dollars of premium written denotes

high operating leverage and technical reserves exceeding three times capital indicates high financial leverage.

The relative priority of claim of Qard-e-Hasanah offered by the SHF vis-à-vis other obligations, is also an important rating factor. For instance in Malaysia, Qard-e-Hasanah is not explicitly subordinated to the interests of policyholders. In Pakistan, however, this is not the case as the company is only required to pay Qard-e-Hasanah from underwriting surplus. This is considered positively as u/w surplus is arrived at after taking all claim expenses as well as 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. Therefore, policy with respect to creation of surplus equalization reserve is considered 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 therefore makes more sense. JCR-VIS also considers the extent of ring-fencing amongst the surpluses generated by various product lines 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 and may not be viewed positively.

A general takaful company's liabilities contain an additional uncertainty factor. Both the timing and the amount of liability are uncertain imposing additional liquidity requirements. 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 including re-takaful arrangements while the investment portfolio is a secondary source of cash flows which may be liquidated, if required.

As Takaful companies are obligated to invest only in Shariah compliant assets, it limits the spectrum of investable assets. We believe that 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. In a market like ours, the level of systematic risk is much higher and considered less diversifiable, as also witnessed in the recent downward slide of key index of Pakistan. Due to this factor, we have a glass ceiling for Takaful operators.

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, just like the capitalization analysis. The investment portfolio risks would be evaluated as per traditional terms. JCR-VIS will not just assess the liquidity of the assets but concentration in terms of exposure, credit worthiness of counterparties and any impairment in the portfolio.

Re-insurance arrangements have an important role in the overall rating assessment. 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 this scenario, the strength of re-insurance arrangements would be evaluated on a case by case basis.

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.

Bearing in view the Takaful model employed, 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. Unlike AMCs, there is no maximum fee limit laid down in regulations for either the wakala fee or the modarib's share.

Having said all this, we believe that future challenges and opportunities include the development and harmonization of the regulatory framework and prudential standards for the Takaful industry. A takaful firm's ability to withstand shocks is usually affected by its market outreach and the spread of business. Smaller companies are generally exposed to higher concentrations risks, 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 while the creation of strongly capitalized global re-Takaful operators will also continue to bear impact on ratings.

## **JCR-VIS Credit Rating Company Limited**

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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. We are currently in the process of undertaking first such assignment in Pakistan and hope to bring greater transparency to the financial markets JCR-VIS