VIS

GENERAL INSURANCE

Rating Methodology

The dependability and resilience of a country's insurance providers is vital to ensuring the health of its financial sector and enabling steady economic growth. The insurance sector in Pakistan is dominated by a few large players while the remaining participants have generally served as captive insurance companies to their respective groups and associated companies. As such, the structure of the local insurance sector puts the market at a disadvantage by limiting the choice of insurer and bargaining power of insurance buyers, and introducing inefficiencies into the system, both in terms of product pricing and service quality.

An Insurer Financial Strength (IFS) rating is an assessment of an insurance company's capacity to meet its contractual obligations that mainly constitute claims on insurance policies. The level of risk faced 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 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, and the entry & exit barriers in effect, have a bearing on the opportunities that the company can capitalize upon, and threats it may encounter.

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Company specific analysis includes a combination of qualitative and quantitative factors. Management expertise and strong internal controls eventually translate into a healthy financial position. Furthermore, ownership structure, business strategies and corporate thinking that drives the institution, are important determinants of an entity's prospects.

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, 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.

In the following pages, primary drivers of IFS ratings and certain key quantitative benchmarks have been discussed.

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. The Insurance Ordinance 2000 had set minimum capital requirements (MCR) for insurance companies, which resulted in a number of mergers, right issues and a few closures. However meeting the MCR does not necessarily imply sufficient capital. Adequacy of capital is evaluated in the context of the segment-wise exposures and historical loss trends in these segments. Further, JCR-VIS analyses the strength of an insurer's capital base through various leverage ratios measuring the level of business written and technical reserves against the level of capitalization. A rupee of capital supporting more than three rupees of premium written denotes high operating leverage and technical reserves exceeding three times capital indicates high financial leverage. Technical reserves and surplus collectively forming an amount in excess of one and a half times premium written is generally considered an adequate shield against potential losses.

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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 to have been insufficient, on an average, to meet losses net of reinsurance recoveries.

If a company is part of a larger group, any form of implicit or explicit support available from the sponsors and group serves as credit enhancement. For this purpose, strength of the sponsoring group as well as diversification of its business lines is analyzed.

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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 flow, while liquidation of the investment portfolio is considered to be a secondary source, necessitated only in the event of extraordinary claims. JCR-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. The solvency margin is also used to assess coverage against obligations. The Insurance Rules 2002 have amended guidelines for the admissibility of assets to determine the solvency margin of a company.

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.

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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.

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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 & 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.

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. A combined ratio[1] of less than 105% denotes an adequate measure of underwriting profitability.

Investment income serves to dampen the stress on underwriting streams. In a high markup environment, a combined ratio greater than 105% may be sustainable, since sufficient investment income may be generated to cover for underwriting losses. Diversification in sources of investment income and quality of these investments is therefore an area of interest while assigning ratings.

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Reinsurance

Reinsurance arrangements are integral to the mitigation of insurance risks. An insurer's relationship with its reinsurers and the financial standing of reinsurance companies on its panel are an important consideration in assigning ratings. Ratings of reinsurers assist in forming an opinion on their financial strength. In recent years, despite capital injections in many reinsurance firms and increasing premium rates, international reinsurers have remained under stress and are still settling previous losses. Since the beginning of 2002, a leading rating agency has downgraded 47 reinsurers out of the 150 largest reinsurers. Of the top 25 global reinsurance groups, 12 are on Credit Watch and carry long-term negative outlook[2].

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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. Following the events of September 11, 2001, the international reinsurers have started limiting their exposure in the Pakistani market, particularly in the smaller companies. Reinsurance treaties have generally been agreed at stricter terms. Maximum probable loss calculations have become more stringent and loss participation clauses have been added to treaties. Certain exposures, e.g. terrorism cover, have also been excluded, while caps have been imposed on maximum loss per event and losses from natural calamities. As such, dependence on local reinsurers and those, which are not highly rated, has increased.

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.

[1] *Claims Ratio + Expense Ratio*

[2] *American Association of Insurance Services, "What do reinsurers want?" : Winter 2003, Vol. 27, No. 3 issue of Viewpoint*

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.

Management & Controls

JCR-VIS considers management quality and ownership structure a key element in the rating process since it is critical to the overall performance of a company. Team experience & competence, corporate structure and decision-making hierarchy are looked into. The profile of the board members may be a considerable advantage and is gauged through their contribution to the company in terms of providing it a vision and being the main source of business strategy.

Vision, objectives and strategies are viewed in relation to the existing macro environment. Evaluation of the management's strategies, operational 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.

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. The Management Information System (MIS) therefore needs to be robust. 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.

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Controls also involve the systems in place for managing the distribution channels. Quality of agreements with insurance agents, the checks & constraints imposed on the agents' business and timely monitoring of the same is important. While controls on business generation and agents' network have been strengthened through the Insurance Rules 2002, proper implementation of these guidelines needs to be ensured.

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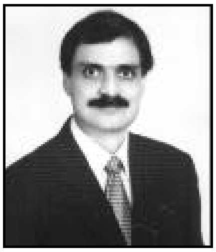

Faheem Ahmad
President & CEO, JCR-VIS
Founder, VIS Group

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.

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Sabeen Saleem currently leads commercial bank ratings at JCR-VIS Credit rating Company Limited. She is also actively involved in ratings of the Leasing and the DFI sector. Prior to joining JCR-VIS, she worked on several projects with local financial consultants.

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Nazia Saleem, CFA, currently leads ratings of insurance and non-banking financial companies. Prior to joining JCR-VIS, she worked as an equity analyst at a reputable brokerage firm.

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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.

Credit Rating Company Limited

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