

## The Pakistan Credit Rating Agency



# Life Insurance & Family Takaful Operator – Insurer Financial Strength (IFS) Rating Assessment Framework

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### Summary

PACRA’s Insurer Financial Strength rating for Life Insurance Companies is a representation of its opinion on a life insurer’s relative ability to meet policyholders’ and contractual obligations. The opinion is not specific to any particular insurance policy or contract but reflects the overall ability of the life insurer. This opinion is arrived at by evaluating the life insurer’s ownership, governance, management, business risk, and financial risks. Overall, PACRA has a more favorable view of insurance companies, which have strong relative positions, underwriting performance, investment performance, enterprise risk management, liquidity, and reinsurance arrangements.

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## Introduction

### Scope

Insurer Financial Strength (IFS) rating of a life insurer is a representation of its opinion on a life insurer's relative ability to meet policyholders' and contractual obligations. The basic objective of this methodology is to enhance the transparency of PACRA's rating process by clearly specifying the relevant factors for the Insurer Financial Strength (IFS) rating of life insurers/takaful operators. PACRA understands the distinction that life insurance carries with respect to its risks and challenges despite its generic commonality with the general insurance business, and hence recognizes the need to document its approach toward rating the life insurer. This methodology draws upon the international perspective and the local experience gained through interaction with the market players and other participants of the broad financial sector of Pakistan.

The private sector was allowed to enter the life insurance market in the early 90s in Pakistan. It compares favorably with the Indian market, where the state-owned life insurer – Life Insurance Corporation – controls ~70% of the market. Despite this comparability, the sector lags in terms of penetration and density compared to regional and international markets. This highlights growth potential as well as the extent of challenges that the sector is facing. Unlike general insurance, the fundamental target market for life insurance is retail, which poses a specific challenge to the industry. Diversity in distribution channels and effective utilization of available resources remain critical to growth. Family takaful operators, following Sharia principles, are also strengthening their foothold in the market. The business model, though having intrinsic strengths, may take a longer gestation period depending upon the extent of emerging competition.

Although this methodology follows a distinct analytical approach compared to PACRA's general insurers' ratings, the rating scale for life insurers' ratings and general insurers' ratings is the same. This is because, despite differences, the ultimate risk being covered is the insurer's ability to meet obligations towards the policyholders. PACRA also believes that, insofar as obligations towards policyholders are considered, there is no difference between life insurance companies and family takaful operators, and the latter would simply be employing Islamic principles for the structure of the business. However, the efficacy of these principles and the operators' adherence to them would remain the prerogative of the Sharia advisors of the life insurer. This entails that the IFS rating assigned to the family takaful operator would not be an opinion on the accuracy of the Sharia principles and quality of the operator's adherence to these principles, but rather on its ability to meet obligations towards policyholders.

### Rating Framework

The liabilities a life insurer covers belong necessarily to the future period. Therefore, it is of utmost importance that the financial indicators of the life insurer remain stable over the medium term. Consequently, the approach that PACRA has employed is a blend of qualitative and quantitative data. The quantification helps in achieving objectivity in the rating process, while the qualitative side helps in establishing the sustainability of the relevant factors in the foreseeable future. Neither can all factors be quantified, nor do quantitative values portray the whole story. PACRA, therefore, seeks to employ the best combination of both to ensure comparability between ratings over time. Overall factors are categorized under these key areas: Profile, Ownership, Governance, Management, Business Risk, and Financial Risk.

**Digital-only insurers:** In August 2022, the SECP introduced a registration regime for digital-only insurers and dedicated micro insurers to promote digitalization and innovation. This framework is expected to enable the expansion of the insurance product range in Pakistan and greater financial inclusion. The factors described in this methodology apply to traditional as well as digital insurers.

### Qualitative Rating Factors

Ownership	Governance	Management
<ol style="list-style-type: none"> <li>1. Ownership Structure</li> <li>2. Stability</li> <li>3. Business Acumen</li> <li>4. Financial Strength</li> </ol>	<ol style="list-style-type: none"> <li>1. Board's Structure</li> <li>2. Member's Profile</li> <li>3. Board Effectiveness</li> <li>4. Transparency</li> <li>5. ESG Considerations</li> </ol>	<ol style="list-style-type: none"> <li>1. Organizational Structure</li> <li>2. Management Team</li> <li>3. Management Effectiveness</li> <li>4. Claim Management System</li> <li>5. Investment Management</li> <li>6. Risk Management Framework</li> </ol>

## Profile

### Background & Operations

PACRA reviews the background of the life insurer to understand its evolution from where it started to where it currently stands. We analyze how and through what means the life insurer has achieved its desired expansion. PACRA looks at the progress of the life insurer from its historical past. The progress of the life insurer helps PACRA in determining the ability of the life insurer to successfully realize its strategy. The significant factor here for PACRA is to assess whether the life insurer has achieved its expansion through organic growth or through acquisitions. Meanwhile, the source of funding for desired growth is also critical.

The assessment of operations of the life insurer depends on the exposure of business segments and the lifecycle stage the business is in. Here, PACRA reviews the diversity and geographic spread of operations, product offerings, size of the franchise/portfolio, track record of operations, adherence to standard operating procedures, and policies and protocols. Size may be an important factor if it confers major advantages in terms of operating efficiency and competitive position.

## Ownership

### Ownership Structure

The assessment of ownership begins by looking at the legal status of the life insurer. The level of perceived stability gradually increases from a sole proprietor to a listed company. This is followed by an in-depth study of the shareholding mix in order to disentangle the structure of ownership. Key factors that are considered for this purpose include the shareholding structure, which includes whether the individual(s) own the insurer directly or indirectly, distribution of shareholding between foreign or local shareholders, whether the life insurer is owned by a single group or through a combination of entities and individuals, and whether it is part of a group or a standalone entity. All these deliberations are done to identify the man at the last mile (or key shareholder). PACRA further considers how a life insurer is actually run, as, at times, entities are operated as family concerns despite being legally structured as companies.

**Complex shareholding/ownership structures:** In cases where the life insurer has a complex ownership structure, there are unique challenges in evaluating the decision-making process, lines of hierarchy, and financial obligations and liabilities. In analyzing these companies, the fundamental issue is to explore the underlying reason or motivation for the complexity of the structure.

**Insurance companies that are owned by private individuals and families:** On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behavior. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting funds from the life insurer as a source of income or to fund other business activities, potentially undermining the financial stability of the life insurer.

### Stability

In order to analyze the stability of ownership, a critical factor to be taken into account is succession planning. An important part of our background analytical work is an attempt to assess whether, and under the right of succession, the life insurer's prospects would be supported and by whom. This is particularly relevant in cases involving family-owned businesses and joint ventures, where disputes among shareholders could have a contagious effect on the sustainability of the life insurer. A stable ownership with clarity in succession, perhaps major shareholding held by a single family or group, is considered positive for ratings. On the contrary, high free float (in case of listed concerns) leads to a risk of takeover and may anchor lower ratings.

### Business Acumen

Here, PACRA gauges the shareholders' business skills. Having a strong business skill set has been critical for the sustainable success of the life insurer. PACRA analyzes business acumen through two primary areas: industry-specific working knowledge and strategic thinking capability. Meanwhile, a deep and applicable understanding of the system is critical to determine how a business achieves its goals and objectives. The scope includes the assessment and understanding of how the shareholders of the life insurer think about and successfully make the correct business decisions.

### Financial Strength

PACRA analyzes the ability and willingness of the major shareholders to support the life insurer both on a continuing basis and in times of crisis. Here, PACRA gives due importance to the behavior of the major shareholders to provide timely and comprehensive support in times of need in the past, the prospective view of key shareholders, in case such need arises, other businesses of major shareholders, and the level of commitment of the major shareholder with the life insurer in providing capital support. In case of no explicit commitment by the shareholders, PACRA attempts to form a view on the availability of likely support. Support, in this context, refers strictly to financial support, rather than operational support. The scope for looking at other businesses of shareholders include overall profiling of the key shareholders in the context of identifying the resources they have, outside the life insurer. Here, the standalone rating of the institution can benefit from having majority shareholders with very strong financial strength and commitment to the business. If, in a group structure, the financial strength of the shareholders is deemed to be weaker than that of the life insurer, this may bode negatively for the life insurer's standalone rating, given the possibility that the life insurer may at some point in time be bound to extend financial support to its weaker parent.

### Information Required on Ownership

- Shareholding pattern
- Details of major shareholders' other businesses
- Shareholders' financial information
- Past pattern of support provided by the shareholders

## Governance

### Board Structure

This comprises the assessment of the board on various criteria, including overall size, presence of independent members, the duration of board members' association with the life insurer, overall skill mixes, and the structure of board committees. The size of the board may vary as per the scope and complexity of the operations of the life insurer. While a very small board is not considered good, similarly, decision-making in an effective and efficient manner may not be possible in the case of a large board. A healthy composition of the board includes the presence of independent/non-executive members having a limited relationship with the sponsoring group of the life insurer. Meanwhile, the chairman and CEO positions being held by the same individual are considered a weak governance practice. The chairman is expected to have a non-executive role. Compliance with the code of corporate governance is also examined. PACRA also examines the independence of the governance framework from major shareholders. Lastly, PACRA evaluates the number of board committees, their structure, and how these committees provide support to the board. A board with a greater number of members should have a greater number of committees in place to assist in performing its role.

### Members' Profile

PACRA collects information regarding the profile and experience of each board member. This helps in forming an opinion about the quality of the overall board. Moreover, diversification in terms of knowledge background and experience is considered positive. However, a fair number of board members should have industry-related experience. Here, the director's training conducted by the life insurer is considered good. This is expected to equip the board members in fulfilling their roles in an effective manner.

### Board Effectiveness

In PACRA's view, the role of the board is to work with management in steering the life insurer to its performance objectives and to provide critical and impartial oversight of management performance. PACRA analyzes the type and extent of information shared with board members, along with the quality of discussions taking place at the board and committee levels. Effective oversight requires frequent sharing of detailed information covering various aspects of business and market development. Meanwhile, PACRA also reviews the number of board meetings held during the year, as these should be justified by the number of issues/matters arising. Board members' attendance and participation in meetings are important and are gauged by viewing board meeting minutes.

### Transparency

The quality of the governance framework is also assessed by the procedures designed by the board to ensure transparent disclosures of financial and other information. This can be achieved by ensuring the independence of the audit committee, strengthening the quality of the internal audit function, which may be in-house or outsourced, and

improving the quality of external audit by engaging auditors who are included in the State Bank of Pakistan’s panel of auditors and/or have a satisfactory QCR rating.

### Environmental, Social, and Governance (ESG) Considerations

PACRA assesses how ESG factors are measured and incorporated into the overall strategy. In this regard, emphasis is placed on the evaluation of board policies and compliance regarding ESG disclosures alongside the adoption of related frameworks and reporting guidelines. The impact of ESG factors on sustainability is also considered, although in the case of Life Insurance and Family Takaful companies, this remains limited in terms of business profile due to the nature of underlying insurance policies.

**Accounting Quality:** PACRA reviews the quality of the life insurer’s accounting policies as reflected in its notes to accounts, auditors’ comments, and other disclosures that are part of its financial statements. Adherence to accounting standards is assessed, particularly for unlisted concerns.

**Quality of Disclosure:** A well-established information system is required for adequate disclosures. The characteristics of quality information include timelines and disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.

#### Information Required on Governance

- Profile of BoD members
- Details of committees including TORs.
- Minutes of the board meetings.
- Information packs for the Board (MIS)
- ESG Framework, related policies and reports
- External auditor details.

## Management

### Organizational Structure

The assessment of management starts with PACRA conducting an in-depth analysis of the organizational structure of the life insurer. On a standalone basis, PACRA looks into the hierarchical structure, reporting line, dependence of the management team on one or more persons, and the coherence of the team. However, PACRA also places the organizational structure in the life insurer’s relative universe for comparison in order to form an opinion on optimal structure within the sector in the context of its complexity. The number of management committees established to monitor performance and ensure adherence to the policies and procedures is considered. PACRA measures the effectiveness of the life insurer by forming an opinion on the quality of management committees.

### Management Team

Analysis of management includes evaluating the experience profile of key individuals, management’s track record to date, in building up a sound business mix, maintaining operating efficiency, and strengthening the life insurer’s market position. Although judgment about the management team is subjective, the performance of the life insurer over time provides a more objective measure. PACRA analyses the quality and credibility of management’s strategy, examining plans for achieving growth. Frequent turnover/loss of key personnel, particularly members of senior management, can

have potentially adverse effects on the overall standing of the life insurer relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with a particular focus on key departments. Similarly, dependence of the management team on one or more persons is considered risky. In addition, the life insurer's human resource policies are also reviewed to gauge its emphasis on retaining and recruiting vital staff.

**Field Staff:** The role of mid- and low-tier staff is critical in maintaining relationships with the policyholders. Any misconduct on their part may lead to deterioration in the institution's underwriting or retention of business. Thus, the life insurer's ability to retain good field staff is considered important while assessing human resource management. Moreover, PACRA attempts to understand the client's staffing policies, fluency in the local language, and their training on social aspects.

**Key-person Risk:** Key-person risk occurs when a life insurer is heavily reliant on an individual, or a limited number of individuals, who are accepted as the key holder(s) of important intellectual capital, knowledge, or relationships. While this type of risk is more commonly identified in small to medium-sized entities, it can also exist in larger entities and is relatively challenging to benchmark and, hence, mitigate. PACRA attempts to identify the extent to which a life insurer is dependent on the expertise of such individual(s) and to ensure policies exist for managerial succession to limit the adverse impact of such a person unexpectedly leaving the life insurer.

### Management Effectiveness

PACRA conducts a qualitative review of management systems and technology infrastructure to assess management effectiveness. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies. One of the key tools available to management to effectively run an organization is the information provided to it. Information available to management must be concise, clear, and timely, so it can be interpreted and understood, and the management can respond accordingly. An important part of this analysis is looking at the life insurer's MIS. PACRA further assesses whether management has developed any critical success factors to evaluate the performance of various business segments and their efficacy. Management meeting minutes are also reviewed, wherever available, to assess the quality of the discussion.

**MIS:** System generated – real-time based – MIS reports add more efficiency in decision-making, whether related to operational, financial, or strategic issues. PACRA evaluates the quality and frequency of the MIS reports used by the management team to ascertain that decision-making within the life insurer is information-based.

### Claim Management System

The Claims department has to be independent of underwriting and marketing. It must be resourced fully, both in terms of manpower and infrastructure, including MIS. A senior, experienced, and independent Head of Claims can ensure that the mandate of the Claims department is fulfilled. In the case of digital-only insurers, claim lodgment, payment systems, and claims processing status are expected to be fully digitalized. Therefore, PACRA may gauge the quality of these systems through soliciting information about vendors or system-generated report samples.

**Claim Settlement System:** Claim settlement begins with the recording of the claim. Claims need to be booked immediately and without discrimination in the books of account; related provisions need to be created, and claims need to be tracked along the settlement process. An efficient claim settlement process depends a lot on technology integration. With technology, all stakeholders may be fully aware of the stage and time further required for the

settlement. Turnaround time is important for a single claim and for the portfolio of claims; this can be monitored through detailed MIS reports.

### Investment Management

Compared to general insurers, life insurance businesses typically carry a long-tail risk. Accordingly, PACRA assesses whether a life insurer's investment management practices align with the nature and extent of the risks it faces. PACRA also evaluates the investment management function on aspects, including: the structure of the function, the experience of staff, the investment policy, and the role of MIS. PACRA emphasizes the quality of the investment committee and the expertise of the investment manager. The investment committee must include members who are adept at investment decision-making, while the investment managers must also be experienced and well entrenched in the equity and debt market depending upon the portfolio of the insurance company, since it is crucial to ensure that assets are adequate to meet the potential short and long-term needs of its liabilities. In addition, the investment policy statement, duly approved by the Board, is the document that lays down the investment philosophy of the life insurer. PACRA assesses whether the statement covers key areas such as proposal generation, decision making, investment allocation, benchmarks, and performance evaluation.

**Market Risk:** PACRA's analysis of market risk incorporates structural risks (such as interest-rate risk management), equity risk, currency risk, real estate and related risks, and/or other trading risks where present. Scrutinizing the duration of the life insurers' liabilities compared to their assets is crucial. PACRA reviews the asset and liability management strategy to assess the risk appetite of the life insurer. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems. Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants would likely pressure a life insurer's ratings.

### Risk Management Framework/Control Environment

This includes an analysis of the life insurer's appetite for risks and the systems in place to manage these risks. PACRA examines the independence and effectiveness of the risk management function, the procedures and limits that have been implemented, limits setting authority, and the degree to which these procedures are adhered to. PACRA endeavors to assess senior management's understanding of and involvement in risk management issues and examine the reporting lines in place. In recent years, there has been a noticeable upgradation in the risk management systems of the life insurers, in the face of increasing guidance and supervision from SECP. Insurance companies are primarily governed under the Insurance Ordinance, 2000.

PACRA evaluates the ERM to assess whether a life insurer executes risk management practices across the enterprise in a systematic and consistent manner. Our primary focus is to assess whether a life insurer addresses risk through silos, i.e., each risk area is conducted as narrowly focused and fragmented activities, or instead adopts an integrated approach across all functions. PACRA also assesses the extent to which the life insurer effectively limits key risks within its appetite to optimally achieve its business goals and objectives. The ERM assessment consists of four sections: role of the board, risk culture, risk exposure management, and risk optimization.

**Operational Risk:** In the context of Basel II and Basel III, operational risk is defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events". Our analysis of operational risk

focuses on a number of issues, including (a) Life Insurer’s definition of such risk, (b) the quality of its organizational structure, (c) operational risk culture, (d) approach to the identification and assessment of key risks (e) data collection efforts, and (f) overall approach to operational risk quantification and management. The extent of technological integration is considered crucial to mitigate operational risks such as fraud, cyber risk, loss of data, and technological disruptions in critical processes. A high degree of automation in day-to-day operations is considered favorable to operational risk management.

**Reputation and Other Risks:** Reputation risk may emanate from operational problems or failure in any risk management systems. It may be difficult to evaluate, but it could adversely affect the life insurer’s rating in cases where it is significant. In addition to reputation risk, any regulatory non-compliance may lead to legal risk with potential ramifications as well.

### Information Required on Management

- Latest organogram
- Profile of senior management
- Redundancy pattern
- MIS reports
- Management meeting minutes
- Life Insurer’s policies and SOP
- A brief write-up on technological infrastructure and the claim management system
- A brief write-up on the risk management framework and the investment management framework

## Quantitative Factors

### Business Risk

1. Industry Dynamics
2. Relative position
3. Persistency
4. Revenues
5. Diversification
6. Investment Performance
7. Cost Structure
8. Profitability
9. Sustainability

### Financial Risk

1. Claim Efficiency
2. Reinsurance
3. Liquidity
4. Capital Structure

## Business Risk

PACRA has a structured approach towards the evaluation of business risk, which integrates all the elements of the insurance business, starting from the premium and ending with the surplus (or deficit) arising from the underwriting and investment operations. There are four components of financial statements to consider in the case of a life insurer, namely, shareholders’ fund, profit and loss account, statutory fund, and revenue account. While the first two represent

the life insurer's own balance sheet and income statement, the last two reflect the underwriting business of the life insurer.

PACRA believes the business risk of a life insurer resides in the revenue account, which implies that the profit and loss account of the life insurer should be viewed independently. This approach stems from an understanding that the fundamental viability of a life insurer emanates from the underwriting operations and the investment income from the premium/investment float. This is core to the business of the life insurer. The shareholders' fund, hence the revenue account, represents a cushion that may be utilized to provide support to the life insurer in initial days or distressed times, but its primary objective is to generate income for the shareholders. In comparison, a statutory fund has an underlying objective of serving the policyholders, depicted as the profit and loss account of the life insurer.

### Industry Dynamics

The process for IFS rating of the life insurers builds on PACRA's understanding of the life insurer industry dynamics. This understanding, following an in-depth research approach, is documented. The analysis captures the placement of the local industry in the international context to see the points of identity and distinction. In terms of identity, the risks and challenges identified for the international players are re-evaluated for the local players, with a view to seeing whether the local players have established effective mitigants against those risks and taken due measures to meet the challenges. At the same time, PACRA identifies the risks and challenges specific to the local context of the industry. While conducting the analysis, PACRA takes a view of the industry alone, independent of the market players. This exercise helps PACRA to form a view on the industry's significance in the economic environment of the country, its regulatory environment, and likely support, if needed.

**Economic Risk:** PACRA analyzes basic economic indicators of the country, including the size and composition of the economy, performance of important sectors, gross domestic product (GDP) growth, inflation, and saving and investment trends. An important part of economic analysis is the positioning of the industry and the impact assessment of economic risk factors on the industry.

**Regulatory Environment:** A well-regulated and supervised system is pivotal for the credibility and stability of a life insurer, even when the operating environment is unfavorable. PACRA's evaluation of the regulatory system involves the evaluation of criteria related to capital and other countercyclical measures to absorb risk, and the extent of regulatory supervision and changes in response to the macro environment and prospective regulatory changes by SECP.

### Relative Position

Relative position reflects the standing of the life insurer in the related market. The stronger this standing is, the stronger the life insurer's ability to sustain pressures on its business volumes and underwriting margins. The standing takes support from various factors, including market size, growth trends, and franchise value/brand value.

**Market Share:** Market size represents the life insurer's penetration in the chosen market. Size is advantageous as it provides the ability to acquire larger businesses, pricing power, and better expense management. There is a positive correlation between the life insurer's absolute and relative size and its market position and brand value. The large companies exercise greater power over the pricing while ensuring commensurate profits. Small companies struggle to obtain business, and with less flexibility in the cost structure, their profits remain low. While absolute size is important, it is basically the relative proportion that provides a clear yardstick to analyze the comparative

strength of the market players. The more distant a player is from the average on the positive side, the stronger its ability to reflect the characteristics just mentioned. In a dynamic industry that is not characterized by concentration, PACRA believes that relative size would better capture the strength of the life insurer's standing in the related market. Having said that, size for the sake of size is not worth it if the life insurer is unable to adhere to underwriting discipline and pricing superiority. The quality of risk management guidelines and their invariable implementation is the key to ensuring sustainability in the market position. Aggressive expansion at the expense of underwriting quality is considered negative, while sustainable growth is viewed positively.

**Growth Trend:** While evaluating the size, PACRA looks at the rate of growth. Growth is important as it ensures that the life insurer continues to have the ability to meet (or beat) the industry's benchmarks. As the industry grows, it uplifts the scale of its operational context. This is reflected in the ability of the players to invest in human resources, upgrade the control environment, enhance the product slate, increase the outreach, and improve the quality of service. To lag the industry's growth trend means to remain short on these avenues, putting pressure on the market position.

**Franchise:** The life insurer's brand reflects the strength of its image and reputation in the market, recognition and perception of its products by the distributors and ultimate clients. The brand also commands the clients' loyalty and the ability of the life insurer to cross-sell, while bringing down its cost of distribution. Typically, higher and sustainable price trends would highlight the strength of the brand and/or franchise value. This would help the life insurer strengthen its market share, ensure a comparative growth rate, and enjoy healthy margins. While a stronger combination of these enables the life insurer to withstand prolonged difficult market conditions, these also enable it to carve out new niches and tap emerging opportunities better than its peers. Consequently, the strength of the competitive position would have a direct bearing on the rating of the life insurer.

### Persistency

One of the measures to gauge brand loyalty, market perception, and reputation of the life insurer is to see the retention rate. Life insurance is generally believed to be a long-tail business, unlike general insurance; therefore, continuation of the premium is fundamental to the life insurance business. A life insurer incurs a lot of upfront costs for the acquisition of the business in view of its long-term retention. Persistency is important from many perspectives. While persistency implies profitability, it reflects that the client is satisfied with the product and the product provider on an overall basis. This, in turn, is a booster for further generation of business. While first-year persistency is a healthy sign, the second year and beyond persistency assures the sustainability of premium inflow to the life insurer. PACRA considers those life insurers to have excellent ability, which are capable of replicating largely the same premium in the succeeding years as in the first year.

### Revenues

In measuring the quality of the life insurer, diversification and stability are very important factors. A life insurer with a diverse product slate with more than one revenue stream is considered better than a life insurer with a concentrated earning profile. PACRA sees concentration at both product and customer levels. In addition, the analysis of target markets to which the life insurer serves forms a part of the assessment. Stability is measured through historical trend analysis of the life insurer's revenues.

### Diversification

Diversification is desirable since it enhances the life insurer's ability to meet challenges, both present and upcoming. Based on this understanding, in assessing diversification across the operations of the life insurer, factors that are considered include distribution channels, premium mix, product line, client concentration, and geographic spread.

**Distribution:** Distribution is the way by which a life insurer reaches out to its clients. The strength (or weakness) of distribution directly affects the business prospects of the life insurer and hence its ability to repay policyholders. Diversity of distribution channels, the extent of their contribution towards the premium base, and the life insurer's ability to exercise control on these channels are some of the important things to evaluate. Diversity in the channels is desirable as it minimizes the life insurer's dependence on any specific channel and reduces the risk of sudden disruption in business. Diversity is important as it provides flexibility in aligning the life insurer's products to the needs of a specific segment of clients. After diversity, the next step is to look at the significance of each distribution channel. By significance, we mean the extent of premium being contributed by each channel. This would help differentiate critical channels from namesake channels. For rating purposes, it is worth only looking at the critical channels. Business acquisition cost, which is an important consideration from a profitability perspective, is also an offshoot of the distribution framework of the life insurer.

**Premium Mix:** The bloodline for the life insurer is the premium it generates. The premium comes to the life insurer in various forms and shapes, mainly determined by the type of policy being bought by the client. The policies may be classified from purely risk protection to saving schemes. The former mainly specifies the risk that these are covering, while the latter represents investments similar to the products of asset management companies. In between both extremes, there is a range of products that blend characteristics of both types, such as whole life, universal life, and endowment. In Pakistan, the predominant nature of products belongs to the mid category, with the element of saving going up in the wake of rising demand for unit-linked policies. Life insurance policies may also be classified according to the type of clients they serve: individual or group. Individual policies, sold to individuals, are viewed more favorably because they represent relatively higher stability and persistency. Group policies, covering a group of people, are usually term-based and normally reflect a higher risk of claims and cessation. With reference to the term, life insurance policies may be classified as permanent or temporary. Permanent policies remain effective until the death of the policyholder or the occurrence of the insured event. In Pakistan, permanent policies are predominantly represented by the endowment. Endowment, apart from the risk coverage during the active period of the policy, has a cash value and therefore provides the sum assured to the policyholder at the maturity of the policy. Policyholders have the option to surrender such policies prior to maturity and avail the cash value at that time. The life insurer remains exposed to the risk of occurrence of the insured event prior to maturity till the time the cash values of these policies are short of the related sum assured. Permanent policies may have a single premium mechanism, whereby the premium comes to the life insurer in one go or represents a regular stream of premiums to the life insurer over the life of the policy. While the regular premium policies provide the advantage of a stable source of revenue, the single premium policies cushion the risk of high payouts due to the occurrence of an insured event prior to the accumulation of cash values. While evaluating the premium mix, although a high value is placed on individual regular premium policies, those life insurers are viewed more favorably that develop an optimum mix of different types of policies, supplementing each other due to the related advantages.

### Investment Performance

The business model of insurance involves the management of insurance float generated from the premiums. This float is invested to make returns. The efficacy of the infrastructure deployed to manage investments can only be gauged through evaluating the comparability of returns and consistency therein. For premium related to pure investments, the life insurer is further exposed to the risk of redemption if competitive performance is not delivered. This is judged through the movement of unit price, as investments normally represent unit-linked policies in Pakistan. The performance of the operator's own investments is compared against the performance of funds maintained for the benefit of the policyholders.

**Quality of Investment Book:** The quality of the investment book is assessed to form an opinion on whether investments are concentrated in high-risk avenues. Apart from the equity investments, which are otherwise viewed in the context of the overall risk appetite of the life insurer, the remaining investments are evaluated from the perspective of the credit profile of the investee. Life insurers generally invest in long-term government securities. Investment in equities, if any, usually forms a minor portion of the investment portfolio.

**Investment Income Contribution:** Investment income is the alternative revenue stream. It supplements the life insurer's profitability. This is the life insurer's earnings over and above the underwriting income or loss, measured through the combined ratio. Investment income contribution is computed by comparing the investment income against the underwriting income. Well-run entities match investment income to underwriting income or supersede it. PACRA evaluates the performance of the life insurer's investment portfolio to determine whether the life insurer is underperforming, meeting, or exceeding relevant benchmarks. It is important to note that PACRA also considers the alpha return generated by the insurer, with the appropriate benchmark adjusted according to the risk of the investments undertaken. Therefore, an insurer that achieves high returns by investing in high-risk assets may not receive a high score unless it outperforms the suitable benchmark for its portfolio

**Strategic Investments:** Strategic Investments are considered good when they are cash-producing; when these are cash-consuming, they may end up pressurizing the life insurer's liquidity. PACRA measures the percentage of cash-producing investments to cash-consuming investments.

### Cost Structure

Cost structure is analyzed for the amount of flexibility provided when market conditions are less favorable. In this regard, PACRA considers how much of the cost base is variable. PACRA also evaluates the performance ratios relative to those of its peers to understand whether costs have been contained while growing assets and revenue. If expense ratios are high, it could be an indicator that the life insurer has a significant fixed cost burden. In this context, a key measure that PACRA looks at is the expense ratio.  $[(\text{Net commission and other acquisition costs} + \text{Management expenses}) / \text{Net insurance premium}]$ . Performance measures are not assessed in isolation, as there may be variations that are caused by business model differences and the importance of ongoing investment in the life insurer's franchise. A low-cost base relative to peers offers the life insurer greater flexibility to deal with competitive pricing pressures.

### Profitability

The clarity as to underwriting and investment operations is important as the life insurer is exposed to different risks with reference to each type of activity, and it can ultimately impact the bottom line. While the underwriting exposes the life insurer to the risk of occurrence of the insured event, terminating into a payout of claim, the investments are

only a matter of fee/commission income and spread of entry/exit depending upon the product profile. Therefore, PACRA believes that both lines of business should be independently evaluated. Takaful operators, being the latest entrant into the market, are alive to this distinction. Their information management and disclosure practices allow independent analysis of both lines. As the industry grows and the competitive environment captures the different dimensions of the life insurance business, PACRA expects that the data and information management and related disclosures would reach – indeed bypass – the benchmark currently set by the family takaful operators.

The surplus or deficit in the revenue account is impacted by various line items, which warrant independent analysis, including claims and management expenses. Another critical item is actuarial valuation, which underlies the life insurer's estimation as to the liabilities arising in the future. PACRA assesses the quality of the actuarial framework deployed by the life insurer. For an in-house actuarial function, the educational and experience profile of the human resource, quality and extent of actuarial working, reports, and the challenges that these are put to are some of the essential elements for the assessment in this regard. For external actuaries, the reputation and franchise value of the firm come into play. The objective is to form an opinion that the liabilities are not underestimated to achieve performance-related milestones.

### Sustainability

Earning prospects are also monitored, based on budgets and forecasts prepared by the life insurance company. A reality check is performed while analyzing the underlying assumption taken by the management, as well as the management's track record in providing reliable budgets and forecasts.

**Event Risk:** Incorporating the risk of unforeseen events into the life insurer's rating opinion is challenging, given their unpredictable nature and the magnitude of impact of the underlying event. These events may be external (e.g., M&As, regulatory changes, litigations, or a natural disaster) or may be internally driven (unrelated diversification, system breakdown leading to significant operational risk, or strategic restructuring) and can lead to substantial rating changes. PACRA applies its analytical judgment in assessing the likelihood of such occurrences and potential impact, insofar as may be possible, and assesses the life insurer's track record, expertise of the management team, and level of financial discipline to incorporate the same into its ratings.

### Information Required on Business Risk

- The life insurer's medium-term business plan.
- Financial projections for the next two years
- Actuarial valuation report
- Annual financial condition report
- Detail of gross premium written from the 25 largest customers for each line of business
- Details of the 25 largest claims intimated for each class of business separately
- Amounts pertaining to disputed claims
- Total sum insured consolidated and for each category separately, and the net share of the life insurer after reinsurance
- Break-up of the investment book of the life insurer

### Financial Risk

#### Claims Efficiency

Timely repayment of claims carries utmost importance in the rating methodology. Claims efficiency represents the pattern in which claims are being settled by the life insurer. PACRA believes that life insurers having a higher rating would be carrying a lower quantum of outstanding claims in general circumstances (adjusted for one-off events). While this ensures ultimate satisfaction of the policy holder, it denotes the spread-out of cash outflows over a number of periods instead of their accumulation in a single period. This safeguards the life insurer from building undue pressure on the liquidity of the life insurer in any specific period.

#### Re-insurance

Re-insurance is the risk coverage obtained by the life insurer against insurance claims. Herein, the business philosophy of the life insurer with reference to risk retention comes into play. A high quantum of risk retention means higher exposure to claims, though profits would be higher as well.

PACRA analyzes the receivables to be recovered from the reinsurers. The analysis of the amount of the life insurer's reinsurance recoverable, its concentrated reliance on a few reinsurers, and the credit quality of the individual reinsurers is important because write-offs of the recoverable as uncollectible could impact the life insurer's income and capital, and the loss of reinsurance capacity could require the life insurer to modify its market/product focus. PACRA looks at the kind of rating the reinsurer enjoys, its experience in the Pakistani market, historical relationship with the life insurer, treaty terms, and its respective share in the reinsurance pool. The major market for life insurance operators is individuals. This implies that the absolute size per risk exposure is bound not to exceed a certain limit except for a few high-profile policyholders. It is therefore expected that cession levels would be on the lower side in the local market with less reliance on the reinsurers.

#### Liquidity

The liquidity profile of the life insurer is the ultimate cover that the life insurer has against claims. The life insurer may carry multiple shields against the claims. The first shield is the operational cash flows coming in the form of premiums/contributions and returns on investments. An effective structure deployed in the operational framework would ensure that a significant portion of claims is being met through the operational cash flows. The second shield is the liquid investment book. The investment book may represent investment in a mix of fixed-income and equity securities. Equity securities are adjusted for those scrips wherein volumes are insignificant. PACRA believes that the mix of the investment book is critical in assessing the overall comfort that may be placed on the liquidity of the life insurer. While exposure towards the equity market may be determined by the investment philosophy of the life insurer, PACRA relates the extent of exposure to the overall risk profile of the life insurer and hence its IFS rating. The third shield of protection is the strategic investment book, if any. PACRA assesses the quality of the strategic book and its size in light of the life insurers' liquidity requirement and the attractiveness of the book for disposal.

#### Capital Structure

At the heart of PACRA's financial risk assessment lies the adequacy of the capital for the life insurer's business. Capital is pivotal for organizational sustainability, growth drive, and as a last cushion against adverse circumstances. Capital,

represented through the shareholder's fund, is essentially the support function in the life insurer's business. PACRA evaluates the capital in the context of the life insurer's business model. This understanding stems from the realization that the life insurer following a high-risk and high-growth business strategy would have an entirely different capital requirement than the life insurer following a conservative business model. Nonetheless, the capital would remain the primary source of energy for both types of companies. While computing and analyzing the capital, PACRA considers the regulatory regime applicable to the life insurers and their internal models, if any, for judging the adequacy of capital.

In December 2022, the SECP issued a concept paper on the proposed shift from the current rule-based capital adequacy framework towards a risk-based capital regime for Pakistan's insurance sector. This transition is envisioned to ensure that the level of capital maintained by an insurer is commensurate with the level of risk undertaken by it. This is expected to more accurately reflect various risks and capital buffers for individual insurers. The new regime would make the Capital Adequacy Ratio (CAR) a key metric for assessing an insurer's loss-absorption capacity. While the capital adequacy levels have not yet been defined, PACRA will consider the applicable regulatory regime, once implemented, in its assessment of the insurer's capital structure. As per S.R.O. 310 (I)/2025, SECP has implemented a revised minimum paid-up capital requirement, applicable to currently operating and new life insurance companies. Therefore, PACRA will continue to assess the capital adequacy position, taking into consideration the revised paid-up capital requirements.

For a viable business, PACRA understands that the capital has to be serviced well. Therefore, analysis of the return on capital and its consistency is another important aspect of capital adequacy assessment. While a life insurer is generating returns, it may have a varied policy with reference to the payout to the shareholders. PACRA believes that this policy should take due account of the existing and future needs of the life insurer's business. Capital formation rate, the rate at which the life insurer adds to the capital after dividends, would determine the accumulation of strength that the life insurer demonstrates on a relative scale.

**Credit Enhancement:** The life insurer that carries a third-party commitment to make good on an amount obligated to the lenders may provide additional support to its financial risk profile. In this case, in determining the impact on rating, key factors to assess are the financial profile of the third party and the extent of coverage – quantum and duration – it provides.

### Information Required on Financial Risk

- Re-insurance arrangements and policies
- List of "Treaties" along with the retention limits and details of surplus lines
- Number of policies above the retention limit and average amount of policy thereof
- Ageing analysis of a) premiums due but unpaid, b) reinsurance recoveries against outstanding claims, c) provision for outstanding claims, and d) amount due to agents
- Statutory returns submitted to SECP
- Break-up of premium: pure insurance premium and investment

### Insurer Financial Strength (IFS) Rating

An IFS rating reflects a forward-looking opinion on an insurance company's relative ability to meet policyholders' and contractual obligations

Scale	Definition
AAA (ifs)	<b>Exceptionally Strong.</b> Exceptionally Strong capacity to meet policyholders' 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)	<b>Very Strong.</b> 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)	<b>Strong.</b> Strong capacity to meet policyholders' 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)	<b>Good.</b> Good capacity to meet policyholders 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)	<b>Modest.</b> Modest 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)	<b>Weak.</b> Weak capacity to meet policyholders' 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)	<b>Very Weak.</b> Very weak capacity to meet policyholders' 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)	<b>Distressed.</b> Extremely weak capacity with limited liquid assets to meet policyholders and contract obligations, or subjected to some form of regulatory intervention or declared insolvent by the regulator.

Outlook (Stable, Positive, Negative, Developing):	Rating Watch:	Suspension:	Withdrawn:	Harmonization:
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.	Alerts to the possibility of a rating change subsequent to, or in anticipation of, some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within the foreseeable future, but may continue if underlying circumstances are not settled. A rating watch may accompany the rating outlook for the respective opinion.	It is not possible to update an opinion due to a lack of requisite information. Opinion should be resumed in the foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.	A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults, or/and f) PACRA finds it impractical to surveil the opinion due to lack of requisite information.	A change in rating due to a revision in the applicable methodology or underlying scale.

**Surveillance:** Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.

**Note:** This scale is applicable to the following methodology(s): General Insurance & Takaful Operator, Life Insurance & Family Takaful Operator.

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