

# **Building transparency and trust**

## **Insight into the rating process for takaful operators**



**Nick Charteris-Black**  
**Director, Global Financial Services**  
**April 2009**

# A.M. Best overview

- Established in 1899 in the US, pioneered the concept of financial strength ratings in 1906
- Only international rating agency focused on the insurance industry
- The world's leading provider of insurer Financial Strength Ratings (FSR) by company coverage
- Coverage of >4000 companies in >65 countries
- Regulatory status - Nationally Recognised Statistical Rating Organisation (NRSRO)

**Seeking to play a leading role in the development of the international takaful market**

# 2008: A Year to Remember (?)



# Impact of the global financial crisis (1)

- Rating outlook
  - significant investment losses
  - liquidity challenges and constraints on capital flows
  - excess capital and recent earnings have provided buffer
  - non-life sector **stable** ; life sector **negative**
  
- Rating methodology
  - Core methodology unchanged but with a sharpened focus on key issues e.g.
    - losses on fixed income
    - equity market volatility
    - liquidity and leverage
    - financial flexibility

# Impact of the global financial crisis (2)

- Rating agency regulation
  - rating of sub-prime structured finance products
  - managing conflict of interest inherent in ‘issuer pays’ business model
  - regulatory response
    - SEC<sup>1</sup>
    - IOSCO<sup>2</sup>
    - EU<sup>3</sup>

1. *Securities and Exchange Commission*  
2. *International Organization of Securities Commissions*  
3. *European Union*

# Potential benefits of a rating

- Facilitates market entry and development
- Business critical requirement (often A- minimum ) for credit sensitive market segments e.g. reinsurance, large commercial business
- Can be perceived as a sign of ‘quality’ and operational excellence
- Reduction in cost of capital/debt and reinsurance
- Can be a focal point for a strategic objective and/or major internal project e.g. in relation to internal capital models or ERM
- Provides independent oversight supporting corporate governance processes
- Satisfies regulatory requirements in certain jurisdictions

**Internationally recognised independent view of financial strength**

# What is an A. M. Best Financial Strength Rating (FSR)?

- An independent **opinion** based on a comprehensive quantitative and qualitative evaluation of an insurance company's balance sheet strength, operating performance and business profile
- Not a **warranty** of a company's financial strength and ability to meet its ongoing obligations to policyholders
- Value depends upon the market credibility of the rating issuer
- A prospective assessment of financial strength based on an **international scale**

A.M. Best's focus is on interactive rating relationships with senior insurance company management

# A.M. Best rating scales

		FSR	ICR		
<b>Secure</b>		<b>A++</b>	<b>aaa aa+</b>	<b>Investment Grade</b>	
		A+	aa aa-		
		<b>A</b>	<b>a+ a</b>		
		A-	a-		
		<b>B++</b>	<b>bbb+ bbb</b>		
		B+	bbb-		
<b>Vulnerable</b>		<b>B</b>	<b>bb+ bb</b>	<b>Non-Investment Grade</b>	
		B-	bb- b+		
		<b>C++</b>	<b>b b-</b>		
		C+	ccc+		
		<b>C</b>	<b>ccc ccc-</b>		
		C-	cc		

FSR = Financial Strength Rating  
ICR = Issuer Credit Rating

# Rating indicators

- Rating outlooks
  - assigned with every rating
  - indication of potential direction over an intermediate term, generally defined as 12 to 36 months

**Positive**

**Negative**

**Stable**

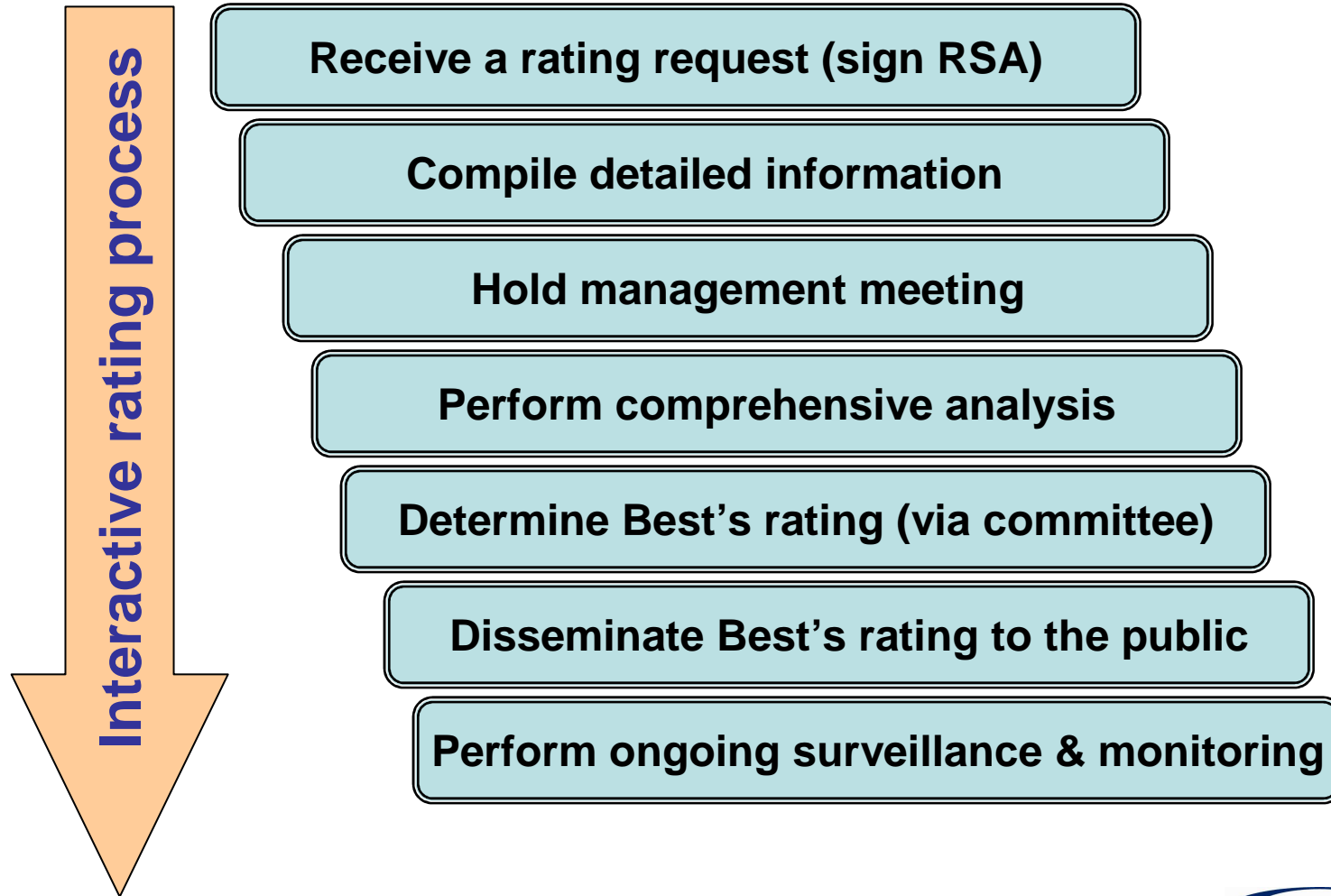
- Under review (u)
  - typically associated with a pending transaction or other significant event that causes A.M. Best to re-evaluate rating
  - short-term in nature...typically, a rating is under review no longer than 6 months

**Positive**

**Negative**

**Developing**

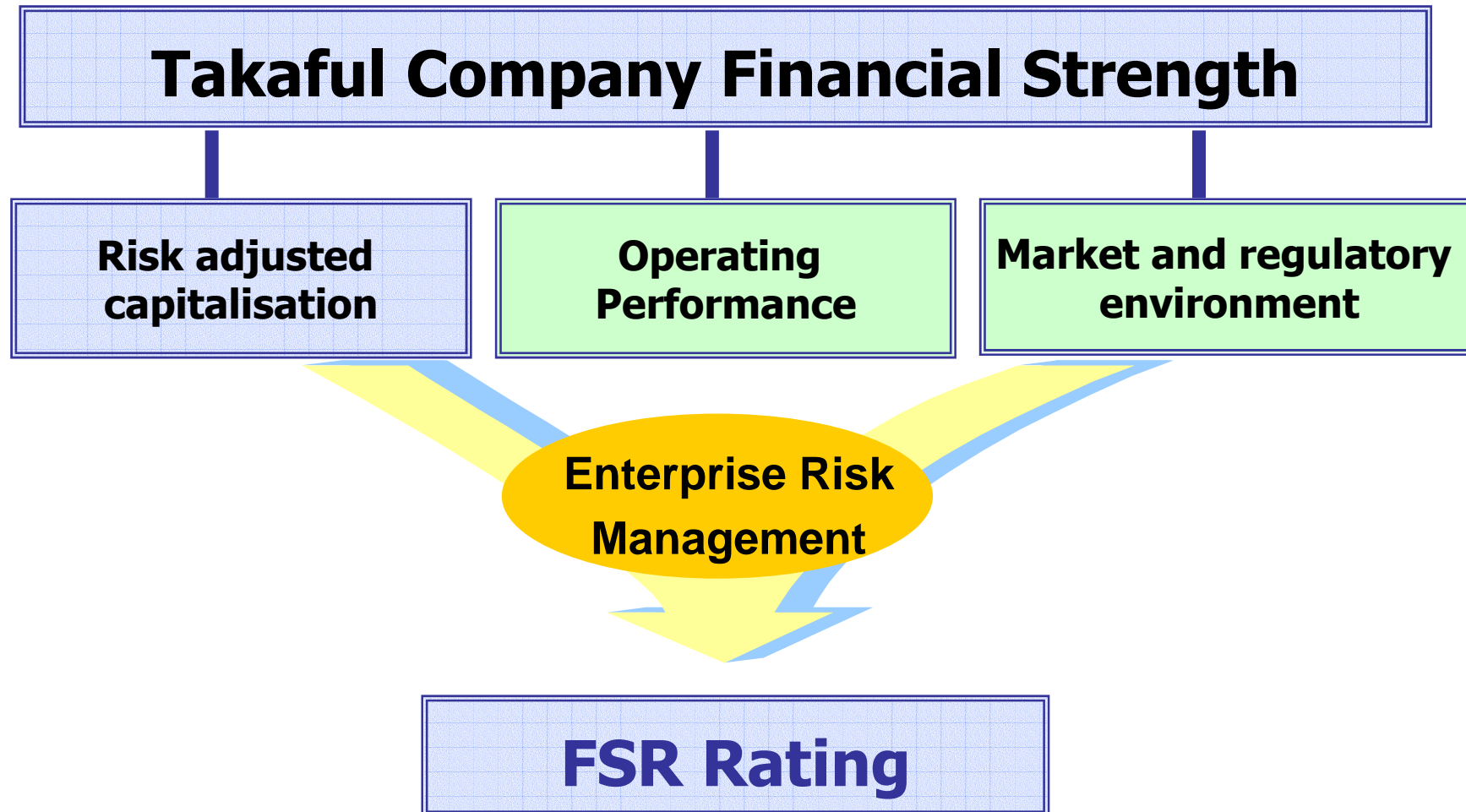
# The interactive rating process – summary



# A.M. Best Takaful methodology

- Specific takaful methodology published February 2008
  - View at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)
- Incorporate many features of standard methodology adapted to reflect unique characteristics of takaful model ; both **quantitative** and **qualitative**
- Will be subject to periodic review to reflect issues arising in the rating analysis and evolving nature of takaful models
- Does not attempt to evaluate the degree of Sharia'h compliance for Takaful companies
- Should be reviewed in conjunction with other methodologies e.g. rating of start ups

# A.M. Best Takaful methodology – key rating components



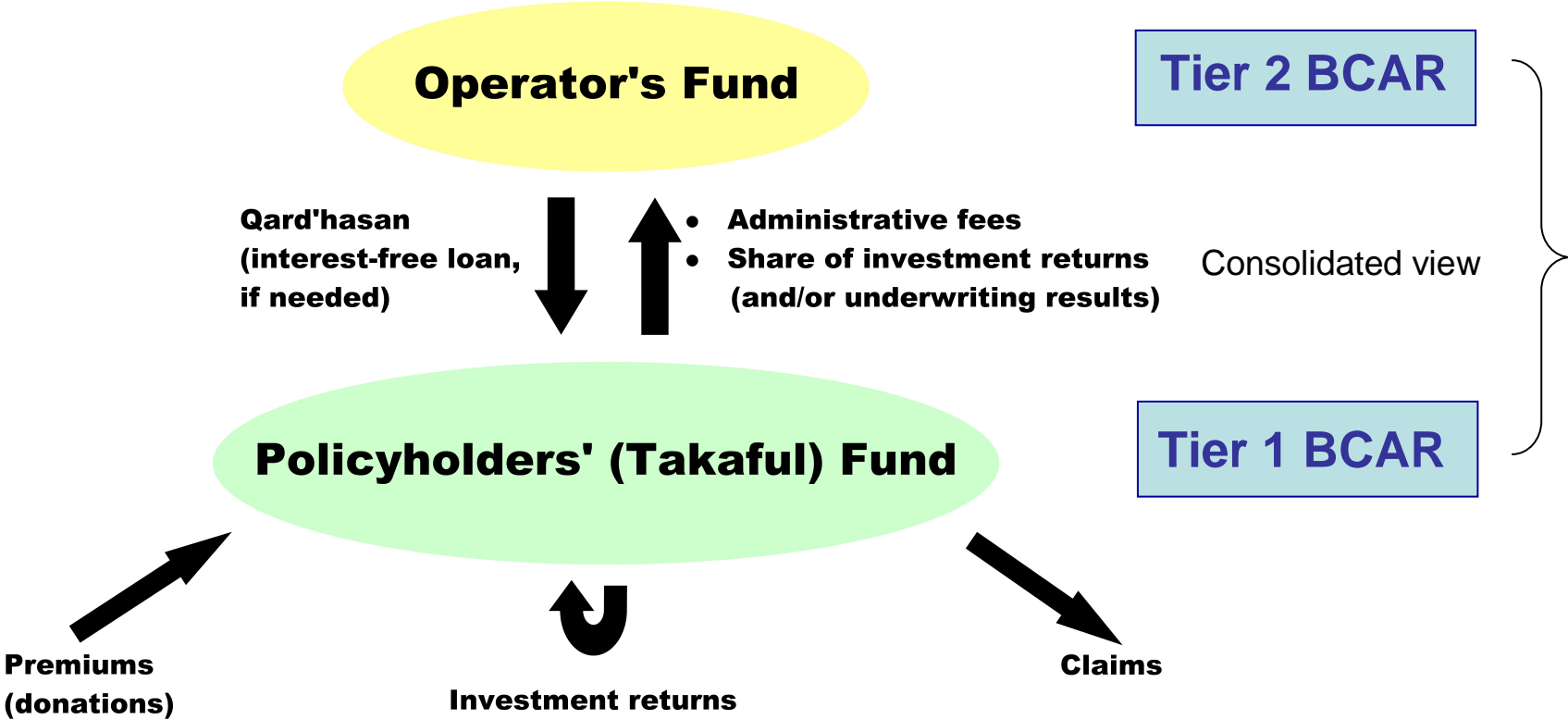
 *Lead indicators of future capital strength*

# A.M. Best capital model - Best's Capital Adequacy Ratio (BCAR)

- Acts as a global 'capital adequacy' benchmarking tool
- Risk based capital model capturing 3 broad risk categories
  - underwriting (and reserve adequacy)
  - investments
  - counterparty credit
- Capital charges determine Net Required Capital
- Policyholder surplus is subject to both positive and negative adjustments to give Total Adjusted Capital
- Best's Capital Adequacy Ratio (BCAR) is determined:

$$\frac{\text{Total Adjusted Capital}}{\text{Net Required Capital}}$$

# Basic Takaful Model – Risk-adjusted capitalisation



# Minimum capital ratios (BCAR %) at various rating levels

Secure		Vulnerable	
RATING	MINIMUM BCAR	RATING	MINIMUM BCAR
A++	175	B	90
A+	160	B-	80
A	145	C++	70
A-	130	C+	60
B++	115	C	50
B+	100	C-	40
		D	0

- Significantly higher ratios are required for start-ups
- Capitalisation is only one element of the rating evaluation

# Rating Takaful Companies

Rating issues	Positives	Challenges
Capitalisation	<ul style="list-style-type: none"> <li>▪ Current strong levels of risk-based capitalisation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Low capitalisation at Takaful fund level</li> <li>▪ Relationship between funds</li> </ul>
Operating performance	<ul style="list-style-type: none"> <li>▪ Comparatively high technical profit margins</li> </ul>	<ul style="list-style-type: none"> <li>▪ High expense ratios</li> <li>▪ Lower investment yields</li> <li>▪ Impact of global crisis</li> <li>▪ Start up risks</li> </ul>
Market and regulatory environment	<ul style="list-style-type: none"> <li>▪ Opportunity to open new markets.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Uncertainty over demand and competitive advantage</li> <li>▪ Country risk</li> </ul>

# Capturing Country Risk

- Purpose is to identify risks unique to a given domicile and common to insurers based or operating in that domicile
- Specific risks assessed by A.M. Best include:
  - insurance market and regulation
  - business and legal environments
  - economic stability and trends
  - financial volatility and banking system stability
  - political and regional stability
- Country Risk analysis is included in the financial strength analysis of an insurance company

**A.M. Best's country risk analysis places no ceiling/cap  
on company ratings**

# Sample Takaful rating meeting agenda

- Organisation structure and overview
- Corporate governance
- Capital structure
- Product development and underwriting
- Marketing and business production
- Claims and loss reserves
- Reinsurance
- Investments
- Financial performance
- Catastrophe analysis
- Enterprise risk management

# Related rating methodology

- Rating Members of Insurance Groups
- Risk Management and the Rating Process for Insurance Companies
- Rating New Company Formations

View at: [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)

**Nick Charteris-Black**  
**Director, Global Financial Services**  
**Tel: +44 (0)20 7397 0284**  
**E-mail: [nick.charteris-black@ambest.com](mailto:nick.charteris-black@ambest.com)**

***For new ratings, please contact:***  
**Clive Thursby**  
**Manager, Business Development**  
**Tel +44 (0)20 7397 0279**  
**E-mail: [clive.thursby@ambest.com](mailto:clive.thursby@ambest.com)**

