



Takaful Summit
London, 1 July 2009

Developments in the Rating of Takaful / Re-Takaful Companies.

Andrew Murray



Agenda

Fitch's Analytical Process

Focus on Selected Takaful Issues

Ratings in the Financial Crisis



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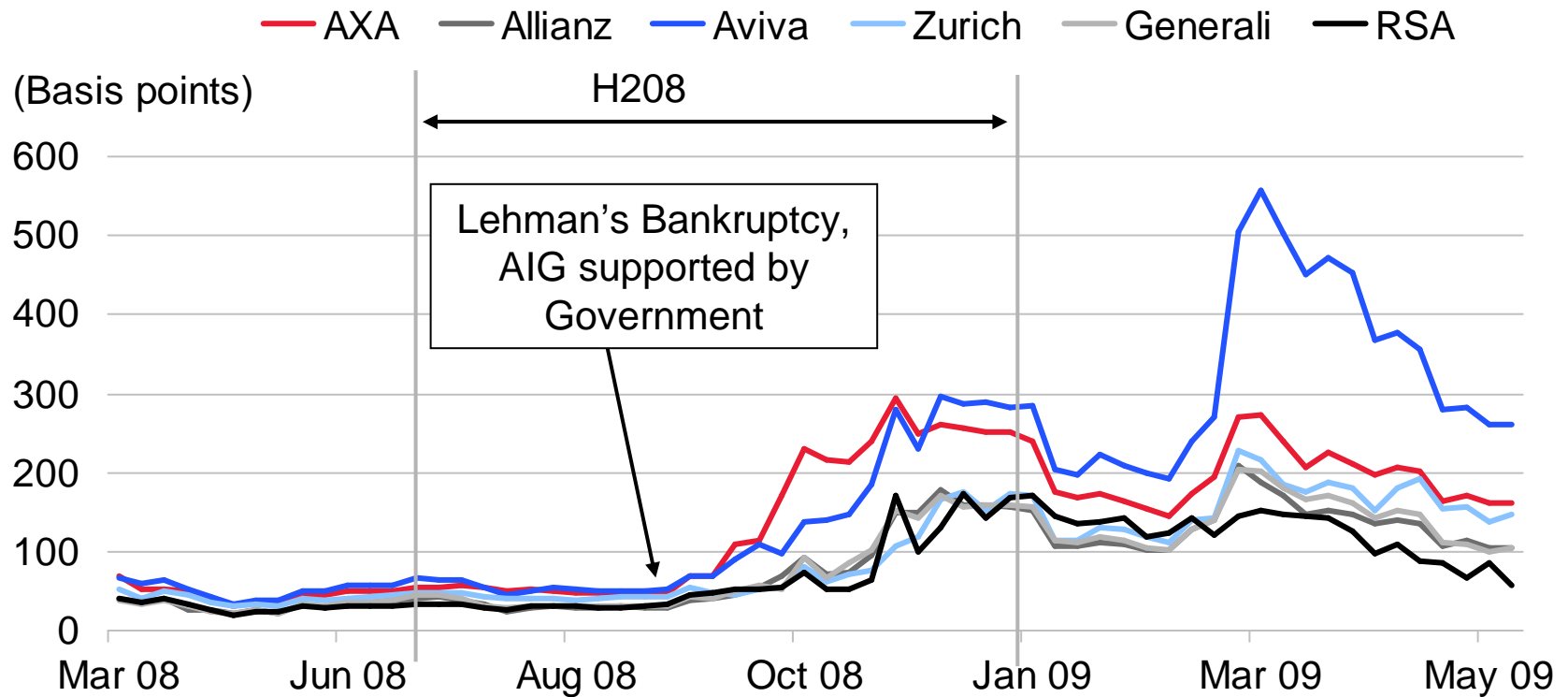
A Difficult Time for Insurance...

- > Recent years have featured
 - Relatively benign claims environment
 - Favourable investment returns
 - Good profitability
 - Strong solvency
- > But, 2008 saw
 - Substantial investment challenges
 - Weaker pricing
 - Continued support from reserve releases
 - Increased uncertainty





Credit Spreads for Selected Major Insurers

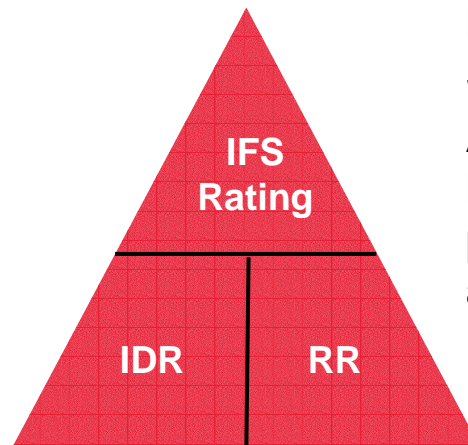


Source: Fitch RAPP, 1 year credit spreads



The Building Blocks of Credit Risk

Fitch does not “approve”,
certify or evaluate
Shar’iah
compliance



Expected Loss

Issue rating (eg Insurer Financial Strength)

An issue rating reflects the likelihood of a specific issue to be paid by the Issuer on a timely basis, as well as some consideration of recovery prospects

Probability of Default

Issuer Default Ratings (IDR)

Issuer Default Ratings (IDRs) reflect the ability of an entity to meet financial commitments on a timely basis

Loss Given Default

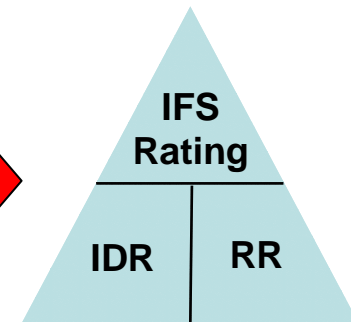
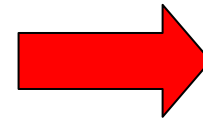
Recovery Ratings (RR)

The Recovery Rating (RR) is based upon the expected relative recovery characteristics of an obligation



Fitch's Takaful Rating Methodology

- > Takaful Rating Methodology Supplements existing Criteria for Conventional Insurers
 - “Non-Life Insurance Rating Criteria (Global)”, 2 March 2007
 - “Life Insurance Rating Criteria (Global)”, 2 March 2007
 - “Reinsurance Rating Criteria: Life and Non-Life (Global)”, 2 March 2007
- > Fitch's Methodology recognises that important differences do exist by country:
 - Attitude to Shariah compliant purchasing differs by region (Turkey, Malaysia, UK, Dubai)
 - Legal and Regulatory Environment
 - Availability of Shariah Compliant Investments
 - Corporate Governance, Risk Management etc.





Ratings Analysis in the Current Environment

- > Application of ratings criteria in context of global recession and capital markets crisis
 - > Ratings criteria not changed – but focus and weighting of analysis adjusted
 - Liquidity
 - Idiosyncratic risks
 - Fixed income / Sukuk securities losses
 - Equity market scenarios
 - Leverage analysis
 - Earnings volatility
 - Diversification/complexity
 - Risk mitigants
 - Government support
-



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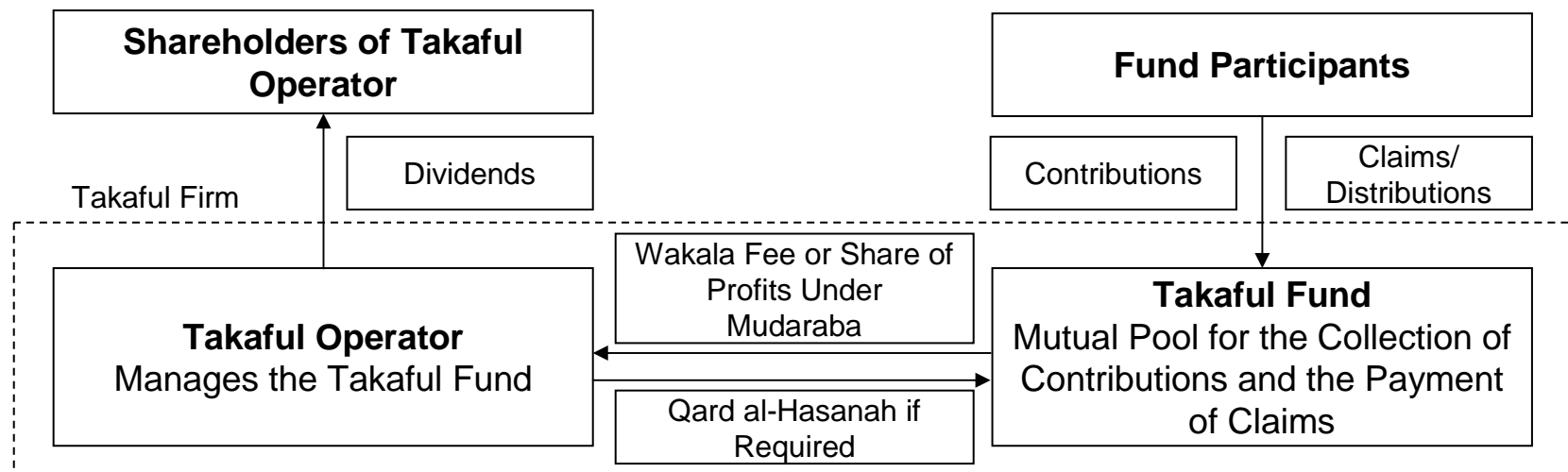


Simplified Diagram of a Generic Commercial Takaful Firm

Selected Important Issues

- > A. Availability of operator capital to Takaful fund participants
- > B. Interest free loan (Qard al-Hasanah)
- > C. Priority of participants in the event of a winding up
- > D. Group rating methodology

**Affected by
Legal,
Regulatory and
Other Factors**



Source: Fitch



A. Availability of Operator Capital to Takaful Fund Participants

The Dilemma

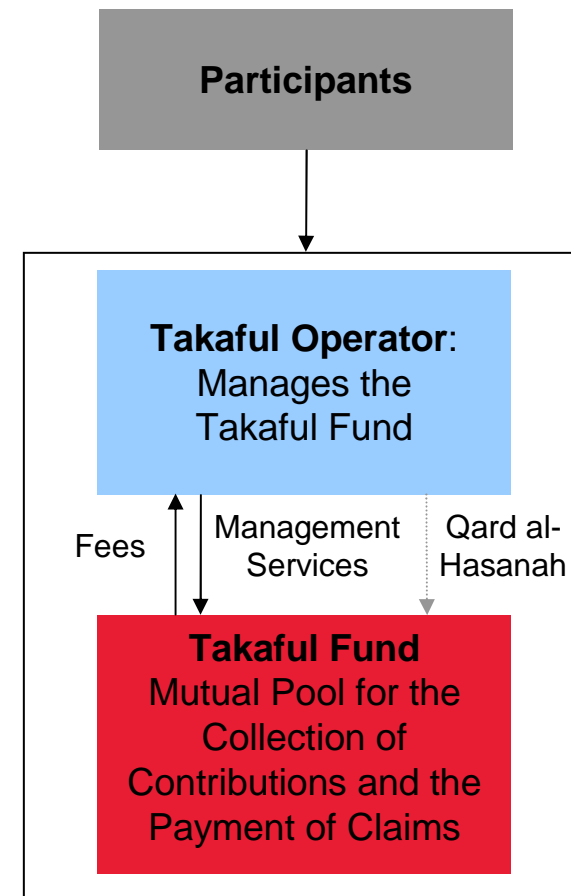
- > 1. Segregation of Takaful operator and Takaful fund is clear under Shariah principles
 - Takaful operator does not suffer downside risk under Wakala or Mudarabah

But

- > 2. Availability of a Takaful operator's assets for the protection of participants is often critical for financial security

Depends on

- > Applicable laws & regulations
- > Wording of contracts and certificates
- > Memorandum and articles of association
- > Can participants rely on this capital in a stress scenario?





B. Interest Free Loan (Qard al-Hasanah)

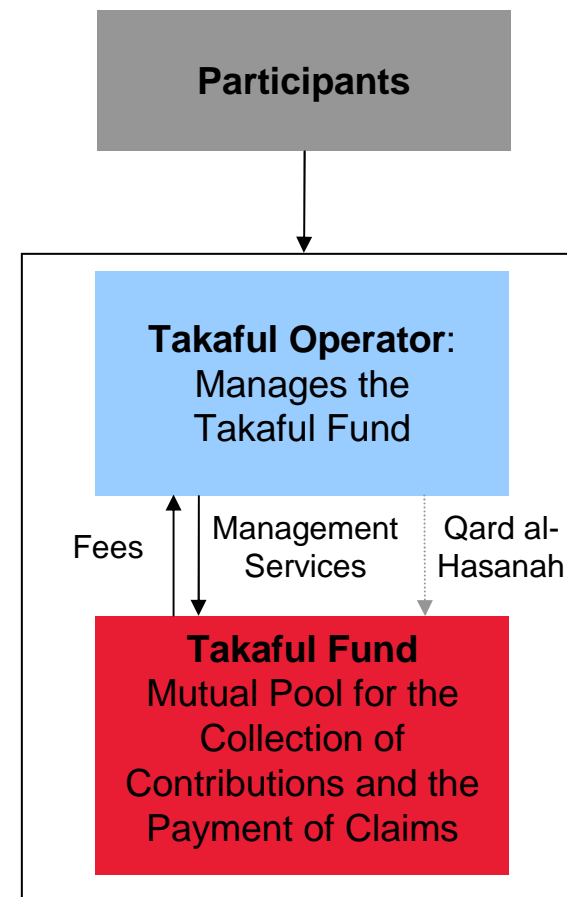
- > Provided by Takaful operator to Takaful fund
- > Mainly provides a short term financing function
- > Much less important if participants have full recourse to Takaful Operator's assets

Credit for existing loans

- > If meets Fitch's hybrid criteria for equity credit
 - Subordinated to policyholder interests
 - Restrictions on repayment (eg can only be repaid from future surplus, no fixed maturity date)
 - OR mandatory conversion to "equity" (ie donation)

Credit for future loans

- > Only if compulsory and suitable triggers exist
- > Must also meet Fitch's hybrid criteria for credit





C. Priority of Participants in the Event of a Winding Up

Description of Regulatory Environments (Select Jurisdictions Only)

Country	Priority of policyholders?
Australia	
Life	Yes
Non-life	No
Barbados	No
Bermuda	Yes
Canada	Yes
Cayman Islands	No
France	Yes
Germany	Yes
Ireland	Yes
Japan	
Life	Yes
Non-life	No
United Kingdom	Yes
United States	Yes
European reinsurers	No
US reinsurers	No

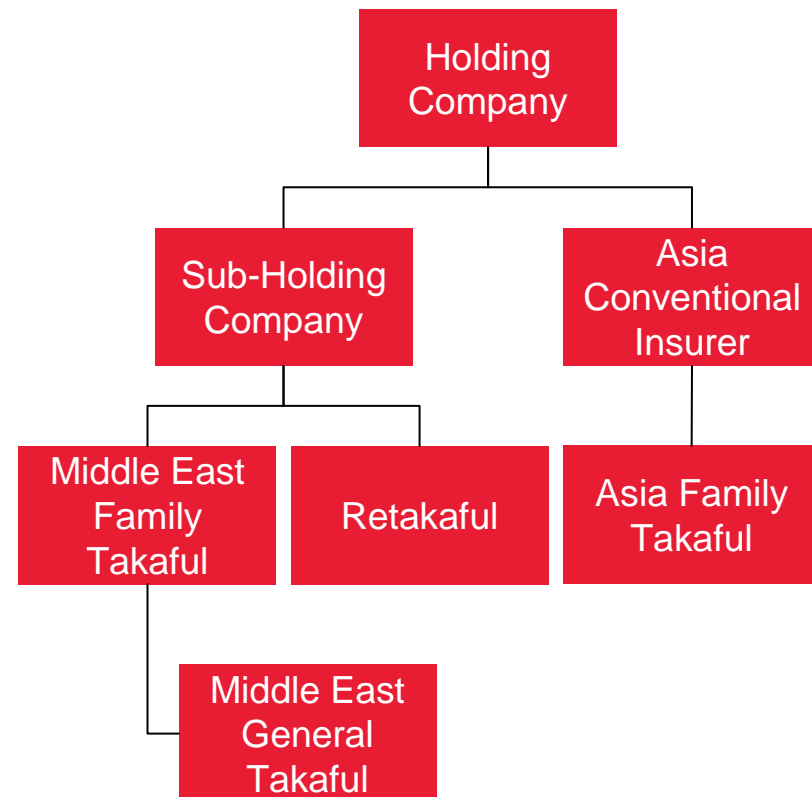
- > **Example: Malaysia**
- > Insurance Act 1996
- > **122.** (1) In the winding up of an insurer, the assets of an insurance fund shall be applied to meet its liabilities to policy owners and claimants under policies of that class of insurance business and **these liabilities shall have priority** over unsecured liabilities other than preferential debts specified under subsection 292 (1) of the companies Act 1965 to the extent that they are apportioned to the insurance fund.
- > **Not necessarily policyholder priority for Takaful firm**
- > No specific provisions in Takaful act 1984

Source: Fitch



D. Group Rating Methodology

- > Having formed stand-alone view of financial strength – Assess potential group support based on
 - **Ability to support**
 - > 1. External barriers
 - > 2. Financial strength
 - **Willingness to support**
 - > 1. Relationship with parent
 - > 2. Support agreements
 - Formal
 - Informal
- > Fitch has internal guidelines to assess how much uplift to apply based on these elements





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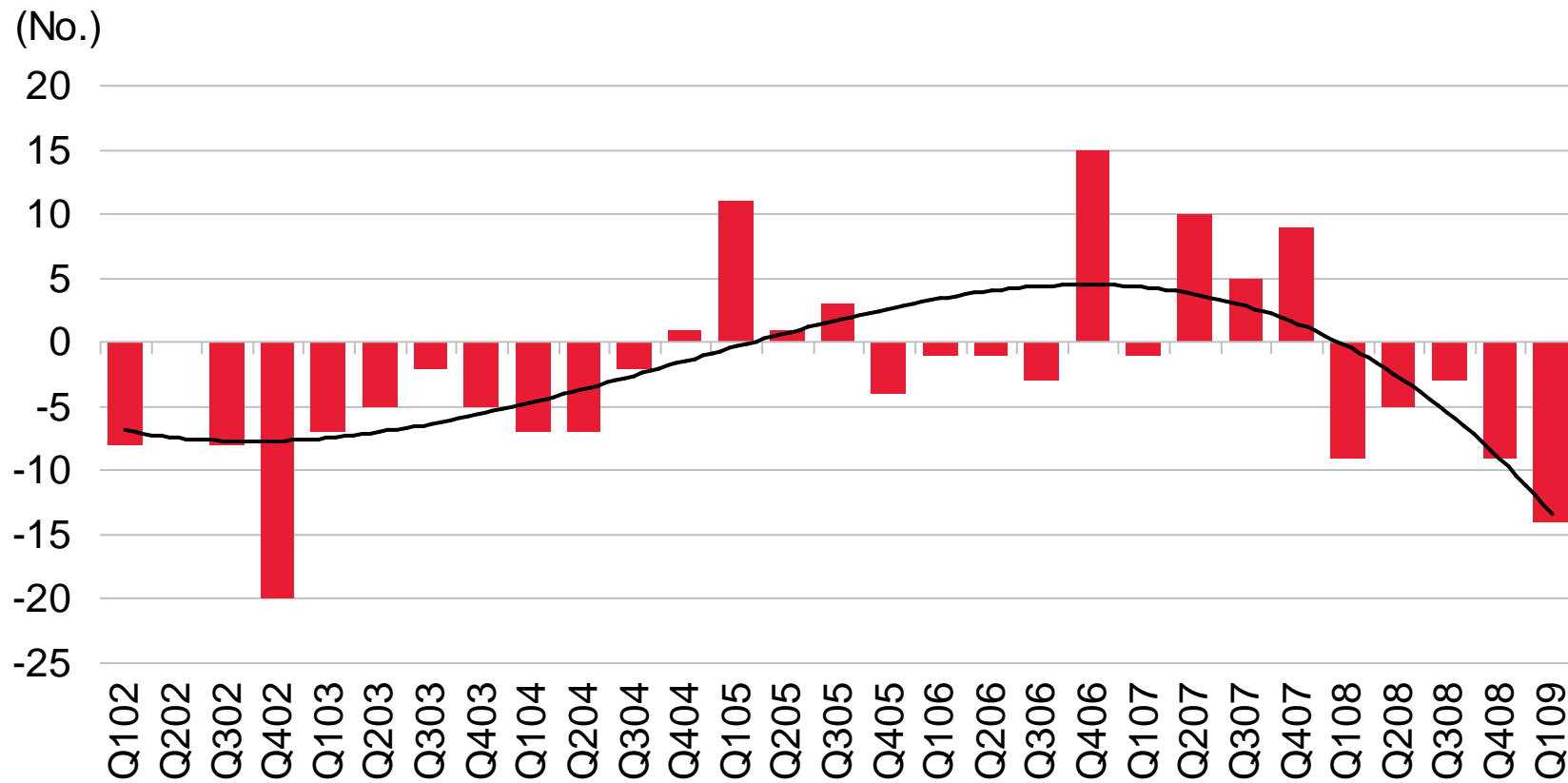
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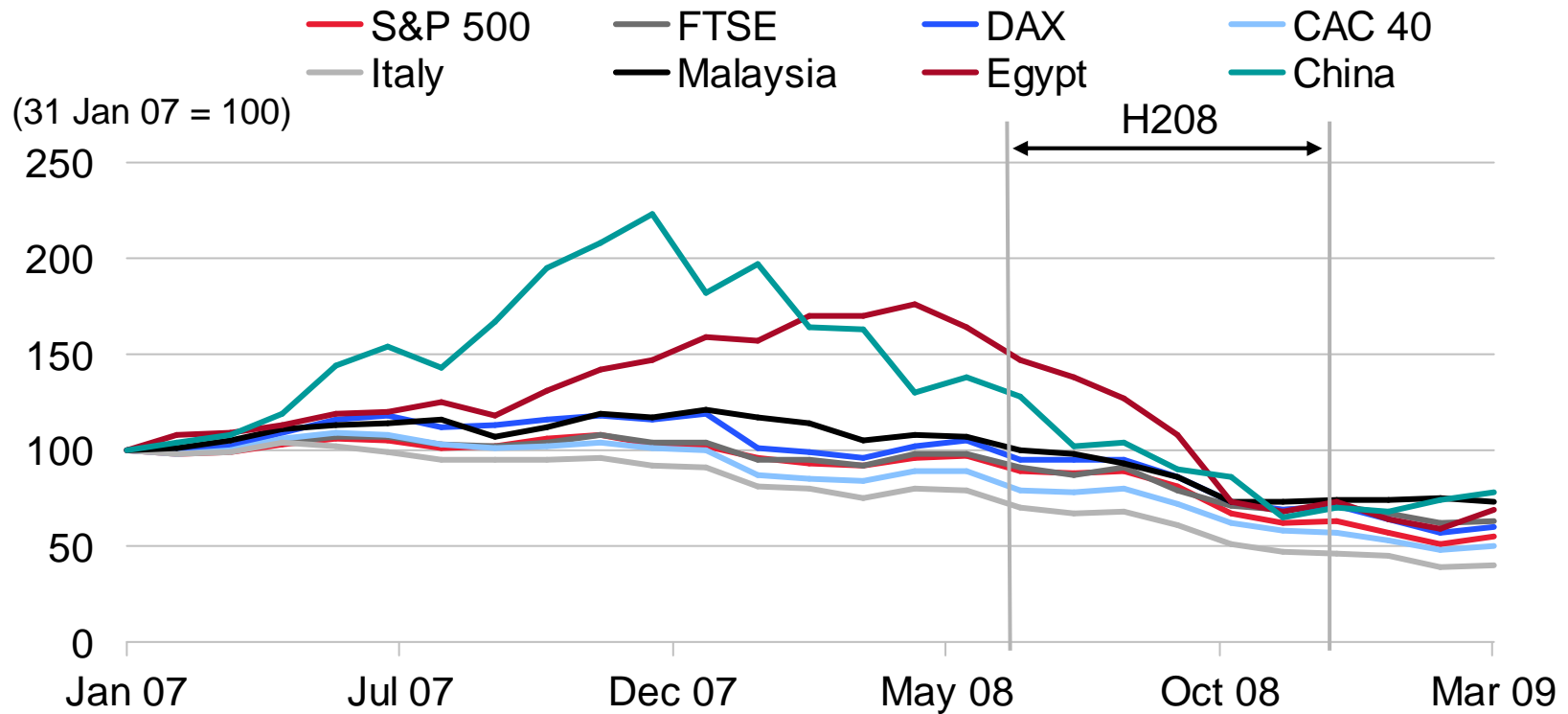
Net Upgrades Less Downgrades



Source: Fitch



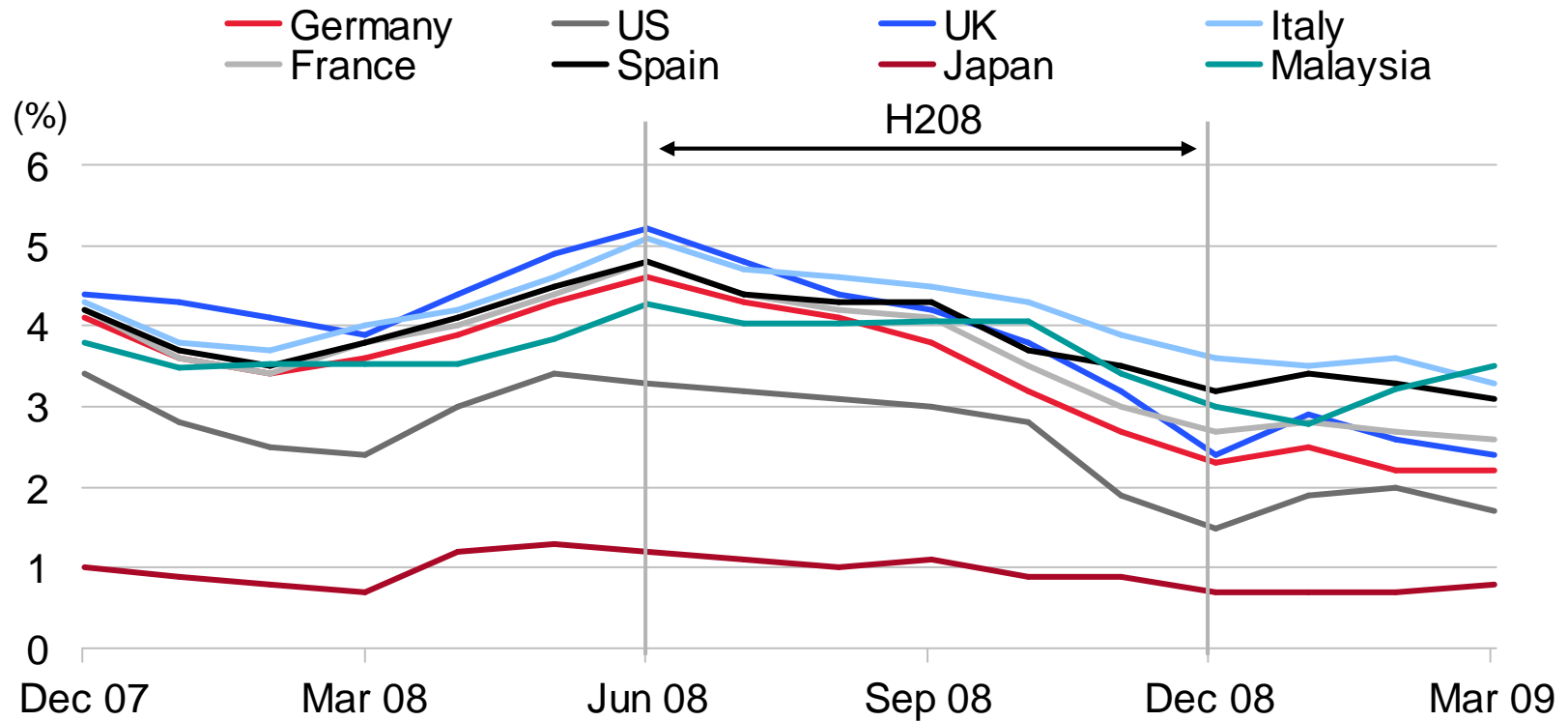
Sliding Equity Markets



Source: Bloomberg/Yahoo finance



Yield on Government Securities Falls Sharply



Source: Bloomberg, 5 year Generic Government Securities



Credit Spreads Increase Substantially

Basis points	2 Jan 08	△	1 Jul 08	△	31 Dec 08	△	31 Mar 09
AAA	6	+5	11	+49	60	+4	64
AA	34	+24	58	+58	116	-13	103
A	46	+31	77	+45	122	+40	162
BBB	61	+69	130	+200	330	-35	295
BB	208	+105	313	+560	873	-138	735
B	414	+165	579	+716	1,295	-304	991

Source: Fitch RAPP



Takaful Developments...

The Takaful Industry has:

- > Avoided investing in Structured and Complex Products
- > Avoided providing Guarantees
- > Limited Investments in high profile failures (Lehman, AIG etc.)
- > Made Some Progress Towards a Clearer Regulatory Environment

But,

- > Losses from Equities
- > Credit losses expected to increase
- > Global downturn affects Takaful firms as well as Conventional Insurers



Conclusion

> **Takaful firms benefit from:**

- Absence of exposure to structured credit market, some other difficult assets
- Absence of guarantees offered
- Generally Low leverage

But:

- Some Takaful firms hurt by high exposure to equity markets
- Credit risk could also cause difficulties, especially where there are investment concentrations

> **Selected Developments**

- Challenging time for Insurers globally although important differences exist between types of firm and specific organisations.
- Some Progress Towards an Exposure Draft on Measuring the Solvency Requirements of Takaful firms
- Greater emphasis on some areas of rating process (investments, liquidity etc)



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Algorithmics

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