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APPLYING INSURANCE CREDIT RATINGS TO TAKAFUL COMPANIES

Insurance ratings are a useful tool designed to help policyholders, professional counterparties and investors in the insurance, reinsurance and capital markets make better-informed financial decisions. To this end, Standard & Poor's has a 20-notch insurance rating scale that goes from 'AAA' ('Extremely Strong') down to 'CC' ('Extremely Weak'), and an array of rating types aimed at different users.

This article will look at the composition of an S&P rating and focus specifically on how the rating process can be applied to the concept of takaful (Islamic insurance). Standard & Poor's has examined the dynamics of the takaful market from the perspective of providing insurer financial strength ratings. We find that although the operational structures and corporate governance concepts for takaful may be unusual, Standard & Poor's can apply its conventional insurer financial strength criteria to primary takaful and retakaful companies.

Types of rating

Standard & Poor's produces two types of rating:

- 'issuer' ratings that relate to a specific company,
- 'issue' ratings that relate to a specific classes of liabilities within a company

It is important to recognise that there is no such thing as an umbrella-like 'group' rating because, in practice, financial strength is usually unequally distributed across the component parts, with unregulated and non-strategic members likely displaying a somewhat greater potential for divestment or collapse than strategically important and undoubtedly core operations.

A Standard & Poor's counterparty credit rating (CCR) is the only issuer rating in insurance, and it indicates the rated company's general ability to honour its highest ranking obligations. Therefore, it can apply equally to a takaful operator's ability to honour its highest ranking obligations. All the other ratings applied to insurers, or takaful operators, are issue ratings as they relate specifically to a single class of liability, whether policyholder obligations or senior, subordinated and hybrid debt. As the highest ranking obligation of an insurer is the one to policyholders, the CCR issuer rating is almost invariably set at the same level as the insurer financial strength issue rating (FSR).

The insurer financial strength rating (FSR) is the 'flagship' rating of the rating process. Clearly, many entities in run-off and even some technically insolvent names are able to pay their contractual claims. Consequently, a basic, ongoing ability to pay normal claims may get a rating in the investment grade (a BBB- or above), but not necessarily higher than a 'BBB' ('Good') level. To rise further up the scale than this, a takaful or retakaful operator must display real, differentiating strengths in areas such as competitive position, operating performance and the quality of its management and systems, as will be discussed further below.

Public or interactive

The first point to consider, in any explanation of ratings, is that there are two basic process types: public information and interactive. Some ratings are based on an analysis of publicly available information such as the annual report and accounts, press reports or regulatory returns. This is known as a public information (pi) rating and is always labelled as such. The process is driven by a demand from the broker community and is not usually applied to relatively new companies where there is not more than three-five years of data.

The interactive approach additionally benefits from face-to-face interaction with the rated company's management, and from the access to qualitative, prospective and confidential information that such meetings invariably bring.

The 'quality control' that ensures fairness and consistency across both the interactive and the public information rating processes is the rating committee. A rating committee typically comprises seven to nine insurance analysts and the committee takes the final rating decision on the basis of one person, one vote, where an invaluable breadth of experience and understanding is brought to bear.

The detail of an Standard & Poor's rating

All long-term ratings can carry '+' and '-' qualifiers to indicate whether they are at the high or low end of their range, although such qualifiers are only very rarely used in the context of FSR's based on public information. With the similar aim of avoiding unsettling step changes in perceived credit strength, outlooks are also attached to CCR's and FSR's, and these outlooks can be supplemented by use of a CreditWatch. What this all means is that if a rating action is not certain but is clearly a distinct possibility over the coming two years due to evolving strengths or weaknesses, then the rating will carry a 'Positive' or 'Negative' outlook, as appropriate. If there is no particular likelihood of a change in the rating, then the outlook will be given as 'Stable'.

Interactive ratings are under constant surveillance and therefore, if a sudden, significant analytical uncertainty arises, such as the announcement of a takeover bid that may well result in a rating action. If resolution of the uncertainty can reasonably be expected within a 90 day period, then the affected public ratings will be placed on either CreditWatch Positive, Negative or Developing. A quick reading of the press release that accompanies the CreditWatch announcement will normally clarify exactly what the issues are and what the most probable outcomes will be, both for the rated entities and for the ratings themselves.

Rating takaful companies

Conventional insurance makes use of uncertainty (in the sense of uncertainty of a claim occurring) and interest in its business practice, thereby creating religious objections to its use by the Islamic community. Takaful is viewed by Islamic scholars as the acceptable alternative – being guided by Sharia principles. The social relationships between the scheme members are also significant, because Islam promotes cooperation and sharing, and a key feature of takaful companies is a contribution to the social good in some form, beyond profit sharing.

In Standard & Poor's view, there is little effective difference between the takaful model and the more traditional type of insurance from the perspective of business practice and the benefits offered to policyholders or members. The basic takaful risk acceptance and sharing mechanism is one used by many traditional insurance companies. Obvious examples are the mutual insurance sector, which operates globally, and the protection and indemnity (P&I) clubs of the international marine market, where mutual members are solely responsible for bearing the cost of risks incurred. In fact, a number of takaful and retakaful operators are members of The

International Cooperative and Mutual Insurance Federation (ICMIF) and the mutual operational structure is favored by takaful policyholders in countries where there is currently no takaful provider.

The operational structures of the cooperative Caisse Nationale des Caisses d'Epargne et de Prévoyance (AA/Stable/A-1+) in France, and the Spanish cooperative savings banks, such as Caja de Ahorros y Pensiones de Barcelona (AA-/Stable/A-1+), in Spain, whose role is that of a nonprofit, beneficent, and social financial institution, are analogous to the takaful model of profit sharing and social support. The Lloyd's syndicate market (A/Positive), where the underwriting members share the risks mutually through the Central Fund mechanism, is also a useful comparison. Lloyd's has a unique structure, but one that Standard & Poor's is able to review and assess for financial strength.

Rating assessment criteria

Any effective takaful credit assessment must be based on a sound understanding of the intrinsic risks of each line of business, complemented by an intelligent balance of qualitative and quantitative analysis. To this end, a Standard & Poor's analysis would ascertain specific sub-ratings in nine analytical areas, notably Industry Risk, Competitive Position, Management & Strategy, Operating Performance, Investments, Liquidity, Capitalization (which includes use of reinsurance/retakaful and the adequacy of reserves), Financial Flexibility and Enterprise Risk Management.

Clearly, competent management, appropriate strategies, a sustainable business position, and a robust balance sheet and income statement are all prerequisites for higher ratings. To achieve useful differentiation in the degrees of excellence between insurers, rating committees will often apply an implicitly 'weak link' approach. For example, a takaful company may enjoy a strong (i.e. 'A') competitive position, liquidity and capitalisation as well as high quality of management. Yet if investments are perceived as a weakness (ie. BB, being, for example, highly exposed to a volatile equity market) then despite all the company's other strengths it would be hard to envisage the committee voting for a final, public rating at anything much higher than 'BBB' ('Good'). But if a company chose to de-risk and diversify investments it could potentially eliminate this drag on its rating.

What do ratings achieve?

A rating provides any policyholder, broker, risk manager, investor, regulator or other interested party with an easy-to-assimilate credit opinion which, like the tip of an iceberg, is supported by an often unsuspected depth and breadth of underlying analysis. Moreover, behind every rating there stands a published 'Rationale' that can be obtained either from the rated company or from Standard & Poor's. These rationales explain the exact strengths and weaknesses of the rated entity, and the expectations and assumptions upon which the rating decision itself has been based

Ratings differentiate the strong from the less strong, and thereby help establish something that is rather more robust and scientific than a simple, subjective ranking of companies. What the ratings do not do, though, is to differentiate 'appropriate' from 'inappropriate'. A company rated 'AAA' promises to be extremely strong not just today but also well into the future, which is essential information when very long term or long-tail or large covers are being sought. However, its policies may be inflexible, its tariffs and quality of service may not necessarily be of the best, and its financial instruments may offer disappointingly low returns to investors.

Meanwhile, an alternative provider rated 'BBB' ('Good') would still give the confidence of being investment grade in terms of its ability to pay claims, while potentially offering attractive contract terms, conditions and levels of service. Ultimately, it is a question of risk relative to reward, which is why lower-rated securities can prove attractive to many investors because they offer significantly better returns. A rating, therefore, is no panacea and does not remove the need for careful thought on the part of ratings users, whoever they may be.

Applying ratings criteria to takaful companies

Corporate governance and enterprise risk management

The religious rigor that takaful companies adopt necessarily inhibits their operational flexibility, and certainly imposes additional corporate governance pressures because they must devise products and services that receive the necessary Sharia board approval. Takaful companies must also operate in the same regulatory environment as all other insurance companies. Nevertheless, Standard & Poor's has sophisticated techniques capable of monitoring any situation that may arise affecting a company's risk management process. Our evaluation of Enterprise Risk Management includes the assessment of Risk Management Culture, Risk Controls, Emerging Risk Management, Risk and Capital Models, and Strategic Risk Management. An insurer's ERM practices can be rated Weak, Adequate, Strong, or Excellent.

Capital and financial flexibility

A major factor for determining financial strength is the ability to maintain and support a company's capital base, particularly in times of strain. As a business expands, the risks that capital is supporting grow and capital will need to increase. Of particular significance is the ability to raise funds to counter any capital erosion. In traditional insurers, capital support comes from profit retention, and short- or long-term capital raising. Due to the specificities of the qard-al-hassan (interest-free loan) arrangement within the takaful operations, shareholders are obliged to support any shortfall in the underwriting pools of the policyholders. Still, takaful companies have access to the same capital-raising solutions, or alternatives such as supplementary calls on participants, depending on the structure of the venture. The effectiveness of these facilities can be monitored by Standard & Poor's.

Reinsurance use and exposure

Through the requirement to operate according to Islamic principles, takaful companies must seek to employ risk-sharing techniques with companies operating under the same banner. Retakaful is part of the solution, and for the burgeoning number of retakaful companies, this Islamic requirement is a boon to their competitive position. To some extent, however, there is also a niche constraint, because the availability of retakaful is dependent on the continued growth of the takaful market itself. Standard & Poor's will review the credit risk and protection available to takaful companies in the same way as for any other insurer.

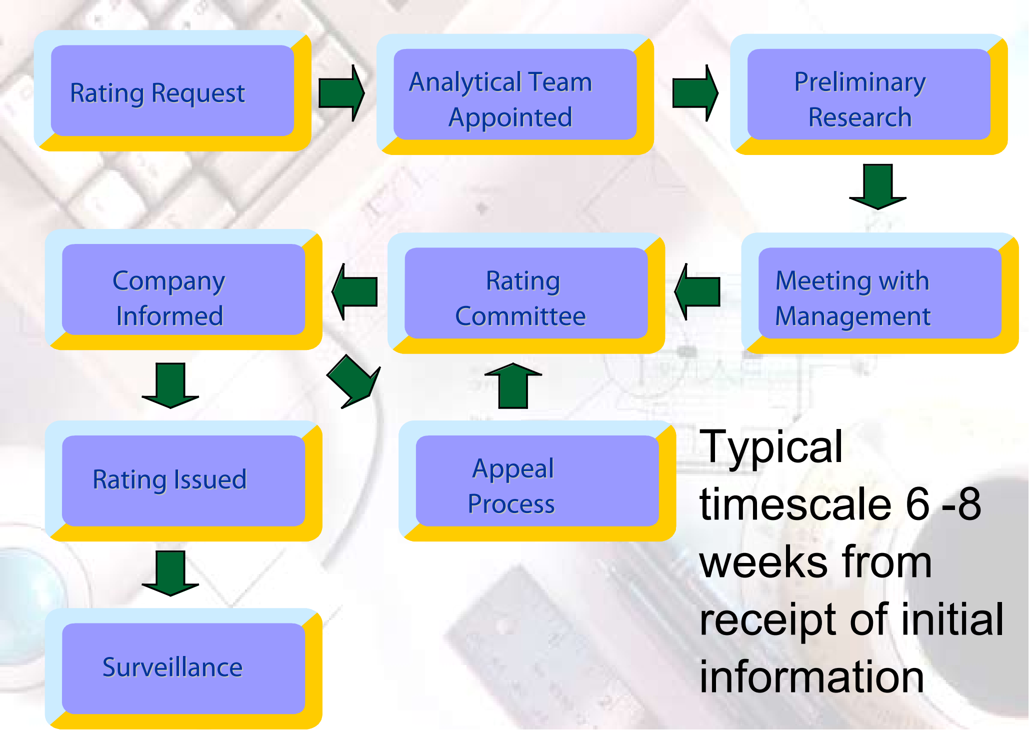
Conclusion

For takaful companies, the lack of development of insurance in the Islamic world gives takaful a significant opportunity to broaden the markets of the interested parties. These include:

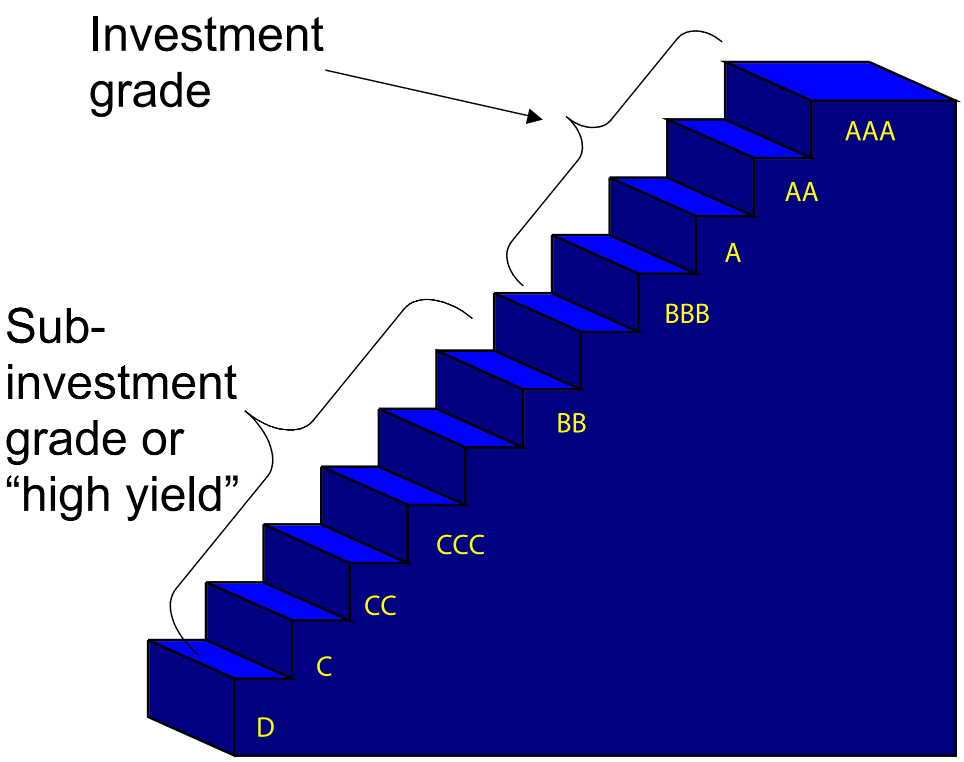
- Existing regional insurers and reinsurers,
- New regional insurers and reinsurers,
- The investment community,
- Governments, and
- The population.

It is difficult to put an exact value on the potential size of the takaful market because it will depend on the ability of takaful to meet policyholders expectations. However it seems probable that takaful companies will attract new clients from the existing "traditional" insurance franchises, and to some extent competitive advantages may be eroded. The significant factor is that the expected rapid growth in insurance penetration across Arab and Asian markets should enable successful business models to prosper. By applying the same rating process to both takaful and non-takaful companies S&P will enable the marketplace to see the relative financial strength of insurance providers.

The rating process



The rating scale



If you would like more information on ICMIF and its services to the takaful sector, please contact Sabbir Patel (*sabbir@icmif.org*), or visit *www.takaful.coop*.