Rating Criteria for General Insurance Companies

General Insurance Companies (GICs) raise capital through subordinated debt or preference shares (called hybrid instruments), to augment common equity. This helps them maintain the required solvency ratio. Brickwork Ratings' (BWR's) criteria for rating these instruments is discussed in this document.

The starting point for rating the hybrid instruments is the Counterparty Credit Risk (CCR) rating of the GIC. The criteria for the CCR rating of GICs are detailed in this document. The rating of hybrid instruments issued by GICs is either equated to or notched-down from the CCR rating. The criteria for the notch-down are also detailed in this document.

To arrive at the CCR rating of GICs, BWR assesses the standalone credit profile, as well as the support expected from the parent entity or group to which it belongs. BWR considers several criteria to arrive at the rating, including the analysis of the company's policies, practices, performance of management, projected business plans and financial analysis, industry and business risks analysis, risk management systems, investment management, use of technology, marketing and distribution channels, and parental and recapitalisation support in the case of new companies.

BWR's rating focuses on critical aspects for the insurance business under the Indian regulatory framework. The insurer's ability to meet its obligations to the policy holders is assessed on the basis of the following key parameters:

- Competitive positioning of the entity
    - Market position of the entity
    - Diversity of products offered
    - Nature of products offered
    - Net retention ratio
- Enterprise Risk Management capabilities
    - Diversity of operations of the entity
    - Risk management policies and systems
    - Reinsurance – risk retained in high-risk products
    - Reinsurer risk
    - Regulatory risk
- Financial Risk
    - Capitalisation of entity – capitalisation ratio, solvency ratio, growth and infusion plans, financial flexibility
    - Underwriting performance – combined ratio, claims ratio, expense ratio, underwriting surplus, operating profit, profitability trend

  - Liability side risk – the fundamental risk arising out of underwriting and reserving
  - Asset Side risk – potential losses arising out of credit risk, market risk, illiquid securities valuation, among others
  - Asset liability management
- Management Strategy, risk appetite, competence and integrity

Competitive Positioning:

Business growth in the GIC depends a lot on its competitive positioning in the market vis-à-vis its peers. BWR analyses the insurer's source of competitive advantage, as well as its overall microeconomic business profile with the aim of evaluating its long-term revenue-generating capability. Key points considered are as follows:

- Company's competitive strengths and weaknesses
- Quality and spread of distribution channels
- Diversification of business mix – by geography, sector, line of business, distribution source
    - Growth rates of premiums – in total and by line of business - on both net and gross bases, generally over five years
- Market share overall and by major lines of business
- Related non-insurance activities, if any
- Net retention of customers every year

The diversity of products is an important factor not only for the insurer to be the preferred choice for customers, but also for assessing their relative risk profile, given that each product has a different risk profile.

Enterprise-Wide Risk Management:

BWR would analyse the insurer's efforts to align the risk strategy with the business strategy. All ERM (Enterprise Risk Management) practices will be assessed relative to the realistic levels of risk at the company and relative to peers with similar risks. BWR evaluates EWRM quality in the following areas:

- Risk management culture
- Risk controls
- Competitive positioning
- Extreme risk management
- Strategic risk management
- Risk management policies adopted and systems implemented to control risks

Diversity in locations, customers and products constitutes the means through which the insurer manages its risk. In addition to assessing the internal portfolio risk controls, BWR assesses how the insurer manages its risk through reinsurance taken for its high-risk products. Lastly, BWR also assesses the regulatory compliances followed by the insurer.

Capital Adequacy:

Solvency is the most important measure of an insurer’s ability to continue to service its policy holders and debt holders, and continue to grow. Solvency is ensured through the adequate infusion of funds to maintain the capital in the entity. IRDAI requires insurers to maintain a solvency ratio (available solvency margin / required solvency margin) of 1.5 at all times. In addition to the current solvency ratio, the growth plans of the insurer and capital infusion plans, along with its financial flexibility to infuse

funds, are important factors considered. Finally, the capitalisation ratio (net premium written to net-worth) is also considered to assess the risk undertaken by the insurer against the capital cushion it carries.

Broadly, the assessment covers the following areas:

- Capital cushion available to support policy holders' obligations and other liabilities
- Balance sheet strength
- Solvency profile of the insurer
- Insurer's potential need for additional capital in the future, and the sources that may be available to meet this requirement

Underwriting:

Sound underwriting policies and practices make up the foundation for the long-term sustenance of insurance companies. While insurance companies make significant investment income, the core profitability needs to come through underwriting surplus, which is dependent on the sound underwriting practices of choosing the right risk-level customers and pricing high-risk customers appropriately. The efficiency of the underwriting is analysed through assessing the insurers' underwriting surplus, combined ratio, claims ratio, expense ratio, operating profit and the trend of profitability over the years. Underwriting surplus is a measure of gross surplus available after incurring the claims, paying commissions and operating expenses. The claims ratio is the ratio of claims to premiums, and expense ratio is the ratio of expenses to premiums. These indicate whether the premium pricing adequately takes into account the possible claims and operating expenses. The combined ratio is the sum of the claims and expense ratios. These ratios can be volatile, and hence, a trend of profitability is required to establish the true profitability of the insurer.

Asset-Related Risk:

BWR reviews the investment policy and portfolio of the insurer. A detailed analysis is done to understand the processes followed by the company to manage market risk, credit risk, and so on, in its investments. The diversification in the investment portfolio into different industries, single name concentration limits and distribution across rating grades is studied.

Asset Liability Management:

Focus areas include the following:

- Interest rate risk and asset-liability duration gap analysis
    - Asset allocation strategies, asset credit quality and asset diversification (by asset class, sector, maturity, issuer)
- Portfolio liquidity

Management and Corporate Strategy:

The quality and credibility of an insurer's management team is a key determinant of the company's success. BW would meet the senior management to understand the risk appetite for the future growth strategy and implementation plan.

These criteria outline the methodology to arrive at the standalone rating of a GIC. The rating further

considers any support that the GIC can get from its parent or group. Public sector GICs are also assessed for the support they enjoy from the government. The parent support is especially key in the initial years of growth of GICs, where the profitability will not be sufficient to support growth in business. In such cases, the standalone rating of the GIC gets notched-up, and the extent of the notch-up is driven by BWR's criteria for notching-up the standalone ratings of entities based on parent/group/government support, which can be found on the BWR website.

The rating criteria of GICs detailed above are for the CCR rating. The criteria for rating hybrid instruments issued by GICs are discussed below.

The hybrid instruments issued by GICs are either perpetual or have a maturity of 10 years. They have a call option at the end of 5 years and no put option. To service interest/pay dividends and for principal payment, the GIC has to maintain its solvency ratio above the regulatory minimum of 1.5. In the event of the GIC making a loss, approval from the IRDAI is required for making the interest/dividend payment. While subordinated debt instruments are cumulative, and so any defaults can be cured later, preference shares are non-cumulative, and a default cannot be cured.

The features of hybrid instruments are similar to those of Upper Tier II bonds issued by banks. Hence, the rating criteria mirror the criteria for Upper Tier II bonds issued by banks. The rating of the hybrids could be equated to the CCR rating of the GIC if it maintains a high cushion in the solvency ratio over the regulatory minimum and is expected to continue to maintain the cushion. This is typically true for GICs with strong parents and hence, high financial flexibility. BWR expects GICs to receive the IRDAI permission to service interest for subordinated debt instruments even if the GIC makes a loss, if the solvency ratio is above 1.5. However, profitability is a factor considered in deciding the notch-down from the CCR rating. For low to no cushion in the solvency ratio and an entity making losses, the rating of hybrids could be up to four notches below the CCR rating.

For preference shares, in addition to the solvency ratio and profitability, reserves available to pay dividends are also assessed to arrive at the possible notch-down in the rating.

The previous version of this document can be found in
https://www.brickworkratings.com/download/Criteria-InsuranceCompanies.pdf

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