Rating Criteria for Life Insurance Companies

Life Insurance Companies (LICs) 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 are discussed in this document.

The starting point for rating the hybrid instruments is the Counterparty Credit Risk (CCR) rating of the insurer. The criteria for the CCR rating of life insurance companies are detailed in this document. The rating of hybrid instruments issued by life insurance companies 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 life insurance companies, 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 the 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:

- Business risk
  - Market position of the entity
  - Diversity of products and operations
  - 13th month persistency ratio
  - Conservation ratio
  - Risk management policies and systems
  - Reinsurance
  - Regulatory risk
- Financial Risk
  - Capitalisation of entity, growth and infusion plans
  - Underwriting performance – underwriting surplus, operating profit, profitability trend, solvency ratio
  - Asset side risk – potential losses arising out of credit risk, market risk, illiquid securities valuation, and so on.
  - Financial flexibility and liquidity

- Management Strategy, risk appetite, competence and integrity

Market Position:

Business growth in the LICs (Life Insurance Companies) 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:

- The 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

While new policies are important for business growth, it is equally important for insurers to retain existing policyholders. These are measured through the 13th month persistency ratio (ratio of policyholders renewing their policies) and conservation ratio (renewal premium collected in the current year to the total premium collected in the previous year).

Business Diversity:

Diversity in 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. Diversity is achieved through a balance of life and annuity products, which have very different risk profiles. Moreover, product diversity is achieved through offering unit-linked plans and traditional life policies, which have different risk profiles, as well as profitability, for the insurer. Diversity in the geographical portfolio of the insurer is equally important to protect it from regional disasters that may impact the insurer.

Enterprise-Wide Risk Management:

BWR would analyse the insurer's efforts to align the risk strategy with the business strategy. All ERM 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 of locations, customers and products are 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 policyholders and debt holders, and continue to grow. Solvency is ensured through the adequate infusion of funds to maintain capital in the entity. The 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.

Broadly, the assessment covers the following areas:

- Capital cushion available to support policyholders' obligations and other liabilities
- Balance sheet strength
- Solvency profile of 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 are 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 insurer's underwriting surplus, operating profit and trend of profitability over the years. Underwriting surplus is a measure of gross surplus available after incurring the claims, paying commissions and operating expenses. These indicate whether the premium pricing adequately takes into account the possible claims and the operating expenses. 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. Diversification in the investment portfolio into different industries, single name concentration limits and distribution across rating grades is studied.

Financial Flexibility and Liquidity:

Insurers need to maintain liquidity for the potential claims of policyholders. Forecasting the asset liability mismatch is key for insurers; however, this unlike for financial institutions is very volatile. While the underwriting cashflows, and quality and liquidity of the investment portfolio are important, funding lines available from banks and financial flexibility to raise funds from promoters are key requirements. 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. BWR would meet the senior management to understand the risk appetite for future growth strategy and implementation plan.

These criteria outline the methodology to arrive at the standalone rating of a Life Insurance company. The rating further considers any support that the insurer can get from its parent or group. Public sector insurers are also assessed for the support they enjoy from the government. The parent support is especially key in the initial years of growth in life insurance companies, where the profitability will not be sufficient to support growth in business. In such cases, the standalone rating of the insurer gets notched-up, and the extent of 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 Life Insurance companies detailed above are for the CCR rating. The criteria for rating hybrid instruments issued by Life Insurance companies are discussed below.

Hybrid instruments issued by Life Insurance Companies 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 insurer has to maintain its solvency ratio above the regulatory minimum of 1.5. In the event of the insurer 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 life insurance company 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 insurers with strong parents, and hence, high financial flexibility. BWR expects Life Insurance companies to receive the IRDAI permission to service interest for subordinated debt instruments even if the insurer 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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