



## Rating Criteria for Life Insurance Companies

### **Executive Summary:**

Life insurance criteria refer to the factors and conditions that insurance companies use to determine whether to offer life insurance to an individual and how to price that policy. These criteria help insurance providers assess the risk they are taking by insuring a person. Brickwork Ratings' (BWR's) criteria for rating these instruments are discussed in this document.

The sectoral cap for Foreign Direct Investment (FDI) in the insurance sector has undergone several revisions. Initially, the cap was set at 49%, but it was later increased to 74% under the automatic route. As part of the Union Budget 2025, the government has announced a further increase in this cap, raising it from 74% to 100%. However, this enhanced 100% FDI limit will be applicable only to insurance companies that commit to investing the entire premium amount in India. This move is expected to strengthen the sector by encouraging more foreign investments, boosting insurance penetration, and fostering competition in the market.

### **Scope of Criteria:**

To arrive at the Counterparty Credit Risk (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.

### **Risk Assessment and Methodology:**

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:

## A. Business Risk:

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:

Competitive positioning of the entity	Enterprise-Wide Risk Management
• Market position of the entity	• Risk management policies and systems
• Diversity of products and operations	• Reinsurance Risk
• 13th month persistency ratio	• Regulatory Risk
• Conservation ratio	

### Competitive positioning of the entity:

- **Market position of the entity:** An entity's position in the market can significantly influence its exposure to certain types of risk, its financial stability, and the complexity of its operations. BWR assesses as per the key factors mentioned below:
  - a. Company's competitive strengths and weaknesses
  - b. Quality and spread of distribution channels.
  - c. Diversification of business mix – by geography, sector, line of business, distribution source
  - d. Growth rates of premiums – in total and by line of business - on both net and gross bases, over five years
  - e. Market shares overall and by major lines of business
  - f. Related non-insurance activities if any.
  - g. Net retention of customers every year

Broader economic conditions, such as inflation, unemployment rates, and overall market volatility, can affect both the insurer's investments and the demand for life insurance policies. A downturn in the stock market could reduce the insurer's investment returns.

- **Diversity of products and operations:** 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.
- **13th month persistency ratio and Conservation ratio:** 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).
- **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 policies and systems:** In general insurance, risk management policies and systems are frameworks and practices designed to identify, assess, and effectively manage risks. By staying within the entity's risk appetite, these policies ensure that the insurer has strategies to minimize potential losses, comply with legal regulations, and maintain financial stability.
- **Reinsurance Risk:** Insurers often use reinsurance to mitigate risk, especially in large or complex policies. If a reinsurance company fails or cannot meet its obligations, the life insurance company may be left with greater exposure to claims. BWR assesses how the insurer manages its risk through reinsurance taken for its high-risk products.
- **Regulatory Risk:** Life insurers operate in a highly regulated industry, and changes in laws and regulations (such as tax laws, health care laws, and solvency regulations) can impact on the entity's operations, profitability, and risk exposure. Insurers must comply with state and federal licensing requirements. A failure to maintain appropriate licenses or meet regulatory standards can lead to legal and financial penalties. Regulators require life insurers to maintain sufficient capital reserves to cover claims and risks. Insufficient reserves can lead to regulatory intervention and a loss of public confidence. BWR assesses the regulatory compliances followed by the insurer.

## B. Financial Risk:

The key factors that BWR considers when evaluating a life insurance entity's financial position in terms of financial risk are as follows:

### 1. Capitalization of entity:

Capitalization refers to the amount of capital (funds) a company has available, which impacts its ability to absorb losses, withstand economic shocks, and remain solvent. For life insurance companies, strong capitalization is crucial because they need to manage large liabilities that can stretch over many years. It entails assessing important indicators for a Life Insurance Company, such as the solvency ratio, shareholders' fund, growth and infusion plans and financial flexibility.

- **Solvency Ratio:** 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.

**Higher Solvency Ratio:** Indicates the insurer has more than enough capital to meet potential claims and other obligations.

**Lower Solvency Ratio:** Suggests that the insurer may struggle to pay future claims, indicating a higher financial risk.

- **Shareholders' fund:** The amount of shareholders' funds (equity capital) that the insurance company must hold to absorb losses and maintain solvency in the face of unexpected financial events. It is crucial for managing financial risk. Insurers need sufficient capital to cover a wide range of risks such as underwriting risk (claims), investment risk (market volatility), and operational risks. Capital adequacy ensures the insurer can meet long-term obligations, and the shareholders' funds provide the first line of defense against any financial difficulties.
- **Growth and infusion plans:** This involves evaluating the insurer's strategy for expansion, including increasing market share, launching new products, or expanding into new regions. Growth plans should be sustainable and backed by solid financial foundations to prevent overextension. Infusion plans ensure that the insurer has the necessary funds to support its operations, particularly in times of rapid growth or when facing unforeseen losses.
- **Financial flexibility:** This refers to the insurer's capacity to adjust and access its financial resources to meet evolving needs and circumstances. It includes the ability to raise extra capital or liquidity, when necessary, through methods such as debt, equity, or other financial instruments.

## 2. Underwriting performance:

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.

- **Profit After Tax (PAT):** It is the amount of profit a company generates after accounting for all expenses, taxes, and interest. A strong PAT indicates that an entity is not only profitable but also well-positioned to manage financial risks and obligations, which is particularly important for life insurers due to the long-term nature of their liabilities.
- **Trend for profitability:** The examination of how profitability measurements change over time in order to comprehend the insurer's long-term financial health is known as the trend of profitability.

## 3. Asset Liability and Liquidity:

Asset liability is assessed to ensure that the entity has sufficient liquidity/cash flows to meet any asset liability mismatch. Since the insurance company can have short- and long-term liabilities, hence evaluation of its asset liability management (ALM) through liquidity coverage becomes a critical part of analysis.

Liquidity refers to the company's ability to meet its short-term obligations and policyholder claims as they arise. Life insurers, which offer long-term products like life insurance, pensions, and annuities, must carefully manage liquidity to handle the unique financial risks that come with the long-term nature of their liabilities. These Companies need to ensure they hold sufficient capital to meet both current liabilities and future obligations. This capital is typically required to exceed certain regulatory thresholds to guarantee solvency and liquidity in times of stress.

Life insurance companies invest heavily in long-term bonds, but fluctuations in interest rates can impact their value. When interest rates rise, bond prices typically fall, reducing the value of the insurer's portfolio. This could affect liquidity if the company needs to liquidate assets to cover claims or expenses, potentially forcing it to sell bonds at a loss.

To analyse this critical parameter, BWR performs the following:

- Interest rate risk and asset-liability duration gap analysis
- Liquidity coverage is measured through cash balances and liquid investments.
- Asset allocation strategies, asset credit quality and asset diversification (by asset class, sector, maturity, issuer)
- Portfolio liquidity, to maintain the portfolio level liquidity, the entities should maintain the healthy cashflow, liquid investment and treasury portfolio to meet policy holders demand at all times. It is important to assess that the insurer is maintaining portfolio diversification and no risk concentrations.

#### **4. Investment Portfolio:**

Life insurance companies typically invest the premiums they receive to generate returns. The types of investments (stocks, bonds, real estate, etc.) and their performance impact the insurer's profitability and ability to meet future claims. An insurer must manage the risks of mismatched assets and liabilities, ensuring the right mix of long-term investments to match their long-term liabilities (claims payments). Poorly structured portfolios could lead to liquidity problems. Life insurers are often sensitive to changes in interest rates because they rely on fixed-income investments (like bonds) for returns. A low-interest-rate environment can reduce returns and strain the company's financials. BWR reviews the investment policy and portfolio of the insurer. A detailed analysis is done to understand the processes followed by the entity to manage market risk, credit risk, and so on, in its investments.

### **C. Management and Corporate Strategy:**

The quality and credibility of an insurer's management team is a key determinant of the entity's success. BWR would meet the senior management to understand the risk appetite for future growth strategy and implementation plan. Therefore, BWR considers the following parameters to determine management risk:

- **Management Strategies:** It outlines the comprehensive plan and strategy developed by the life insurance company's leadership to achieve its long-term goals, maximize profits, and manage risks. This involves setting clear objectives, allocating resources efficiently, and making informed decisions to adapt to evolving market conditions.
- **Risk Appetite:** The level of risk life insurance company is willing to take on to achieve its objectives. It determines the boundaries of acceptable risk by balancing potential rewards with the entity's capacity to absorb losses without compromising financial stability.
- **Competence and Integrity:** Describes the skills, expertise, and ethical standards of the staff and management.

#### **Additional factors in assessing credit risk:**

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. 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.

In addition to the mentioned risks above, BWR also believes Environmental, Social and Corporate governance (ESG) risks and opportunities can increasingly have an impact on the operations and sustainability of business of an issuer. Hence, BWR while assessing the credit profile also assesses the ESG profile of the issuer based on data availability. It may be noted that the impact of the ESG profile of the issuer, both in terms of its strengths and weaknesses, are incorporated in the various management risk related parameters while assessing the credit risk associated with the issuer entity.

### **Conclusions:**

The criteria for life insurance companies focus on ensuring financial stability, effective risk management, regulatory compliance, and customer-centric operations. A life insurer that adheres to these criteria will be better positioned to meet its long-term obligations, provide value to policyholders, and generate sustainable profits for shareholders. Maintaining a balance between profitability, liquidity, and solvency while meeting the diverse needs of customers is essential for the growth and stability of life insurance companies in a competitive and ever-evolving industry.

*The previous version of this document can be found in <https://www.brickworkratings.com/download/Criteria-LifeInsuranceCompanies%20v1.1.pdf>*

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