Rating Methodology - Insurance Sector

[In supersession of “Rating Methodology – Insurance Companies” issued in October 2019]

Background

The life insurance industry in India accounts for approximately 70% of the total insurance industry premium, while the remaining 30% is with non-life insurance companies. CARE’s Issuer Rating for Insurance sector companies is an opinion on a life or non-life insurance company’s business and financial strength and measures its ability to honor policy holders’ obligations and debt payments, if any, as per contractual commitments. The opinion about policy holders’ obligations is not specific to any insurance policy or contract.

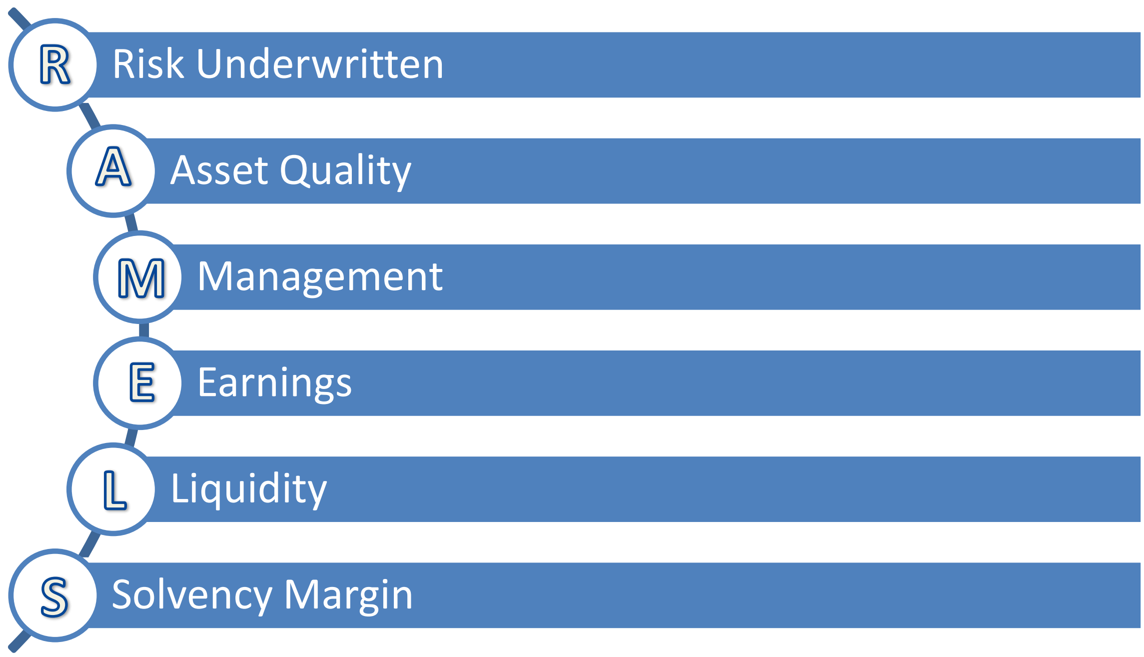
The credit risk assessment of an insurance company begins by analyzing the various risks (management, industry, business, financial risk) at a standalone level. While this would be adequate in many cases, there are situations where entities do not operate in complete isolation and exhibit “linkages” with other companies and corporate entities. These “linkages” often influence the credit profiles of individual entities and hence need to be analyzed while assigning ratings to individual entities. Such analysis is applied as a building block on top of the individual risk assessment of an insurance company. Furthermore, there are situations which require taking a view on a group of related entities while arriving at individual entity ratings or joint ventures (JV) driven by JV partners. Apart from this, ratings of certain insurance companies which are supported directly or indirectly by the state or central government need to address the linkage with the government. For further details on this aspect, please refer to CARE’s Criteria on Consolidation and Factoring linkages in ratings on our website www.careratings.com.

The issuer rating assigned to an insurance company is not specific to any particular insurance policy or contract and does not address the suitability of terms of any individual policy or contracts. Additionally, the issuer rating neither considers deductibles, surrender or cancellation penalties nor does it account for likelihood of the use of a defense like fraud to deny claims. The rating also does not consider any limitation that the insurers might face in settling its foreign claims due to exchange control/sovereign restrictions that might be placed on foreign currency payments by the Government of India.

While analyzing an insurance company’s issuer rating, CARE focuses upon analyzing key ratios with respect to earnings, underwriting performance, liquidity and solvency and reserving policy of the insurer.

Methodology

CARE's analysis of issuer rating begins with a review of the economy and the industry in which the insurance company operates. The nature of insurance regulation and the competitive position of the company are also examined. CARE Ratings then applies the "RAMELS" framework to assess the financial strength of the subject insurance company. Before assigning a rating, not just a single factor is considered in isolation but all the factors are viewed in conjunction.



A detailed methodology based on the RAMELS framework is given below:

Risks Underwritten

Analysis of risks underwritten constitutes the key element in an issuer rating assessment and plays a vital role in the outcome of the rating assigned. The efficacy of a firm's underwriting strength is brought out by its historical claims experience, degree of diversification in risks underwritten and the relative growth in business volumes. CARE Ratings also evaluates the mix of tariffed and non-tariffed businesses, proportion of long tail business as well as exposure to lumpy risks such as catastrophe covers. Each business segment of the insurer is analyzed in depth with an emphasis on understanding its unique competitive characteristics that would drive future earnings potential or cause deterioration in financial strength.

Following factors are considered while analyzing the business segments of the insurer:

- Market share
- Geographical spread
- Diversity of the risks underwritten
- Pricing policy
- Underwriting expertise
- Competitive advantages
- Mix of tariffed and non-tariffed products
- Product innovation
- Proportion of long tail business
- Claims experience and exposure to lumpy risks such as catastrophe covers

A quantitative and qualitative assessment of the above factors is carried out by analyzing the trends in premium income, reinsurance ceded, claims experience and expenses incurred on reinsurance business over five years' time span. Apart from the above, CARE Ratings also assesses the current as well as potential underwriting capacity by analyzing the firm's operating leverage. CARE Ratings also examines the insurer's reinsurance program, terms of reinsurance, financial strength of reinsurers and the company's processes employed to monitor, collect, and settle outstanding reinsurance receivables.

Asset Quality

Issuer Rating of an insurer could be hampered by future losses on its investment portfolio. In respect of insurance entities, asset quality assumes a greater dimension as it influences not only the level of income but also has a direct bearing on the insurer's ability to provide instant liquidity.

Insurance entities are susceptible to credit as well as market risk on their asset portfolio like banks. In this regard, CARE Ratings analyses the quality and diversification of assets across various classes. As most of the asset deployment decisions are largely guided by certain regulatory constraints, CARE Ratings reviews the insurer's level of adherence to regulatory norms and assesses its performance under the specified constraints. CARE Ratings also measures the degree of success of the asset deployment strategy vis-à-vis the slated goals of maintaining a fair degree of liquidity, yield optimization and capital protection. In this context, CARE Ratings broadly examines factors such as:

- Investment philosophy and strategy vis-à-vis the insurer's risk profile
- Portfolio diversification
- Credit quality of investments
- Level of non-performing investments and its NPA recognition norms
- Adequacy of provisioning and
- Liquidity of the investment portfolio

Management

Management quality is a very important qualitative aspect, which can make a substantial difference to a company's performance. Insurers must be able to demonstrate that they are a growing and profitable business with staying power. In this context, CARE Ratings looks at the management's goals, mission, philosophy, etc, and reviews the corporate strategy laid down to achieve the stated goals. CARE's team undertakes discussions with key executives to understand the insurance companies' perspectives on the strategies and plans designed to counter environmental challenges from all fronts. Thus, experience and depth of management to tide over periods of crisis is recognized as a favorable attribute.

CARE Ratings also examines the financial strength and track record of the promoters, the degree of group support enjoyed particularly at times of stress, nature of business plans and targets, experience of key executives manning important positions and the degree of technology orientation. Strong parentage and group support is viewed favorably by CARE Ratings and is examined with respect to past proven support and assurances of future support.

Earnings

Profitable operations are necessary for insurance companies to operate as a going concern. CARE's measurement of earnings focuses on an insurer's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable profit margins. CARE Ratings analyzes the profitability of the underwriting and investment functions separately.

Underwriting Performance

Underwriting profitability is impacted by the level of premium income, agency commission, staff costs and claims experience. Following ratios are analyzed to gauge the underwriting performance of an insurer:

- Premium growth
- Risk retention

- Loss/Claims ratio
- Expense ratio
- Combined ratio
- Investment yield
- Operating ratio
- Breakeven Yield

Performance of Investment operations

Investment income is largely a function of the investment strategy followed by the company. The behavior of the securities market and interest rate movements also influence the returns on the investment portfolio. CARE Ratings examines the following to assess the performance of investment operations in terms of investment yield. Market risk and its probable impact on earnings is also examined.

Overall Profitability

CARE Ratings analyzes the level and trend of the below-mentioned ratios to assess the overall profitability of the insurer. These ratios are analyzed over the past few years and compared with the industry peers.

- Net Earnings Ratio
- Return on Net worth
- Return on Assets

Liquidity

Good liquidity helps an insurance company to meet policyholder's obligations promptly. An insurer's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid or through operating cash flows. A high degree of liquidity enables an insurer to meet the unexpected cash requirements without untimely sale of investments, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

Some of the ratios examined by CARE Ratings for assessing the liquidity of an insurer include:

- Liquid assets vis-à-vis technical reserves
- Liquid assets to current liabilities
- Operating cash flow

While analyzing an insurer's liquidity, CARE Ratings would critically examine the Asset Liability Maturity (ALM) profile of the insurer. CARE Ratings would also examine the impact of stress tests on the ALM to understand the shock absorbing capacity in the event of an unforeseen loss of confidence, sudden catastrophe losses or wide fluctuations in the security markets.

Solvency

Adequacy of solvency margin forms the foundation for meeting policyholder obligations. All insurance companies are required to comply with solvency margin requirements of the regulator. CARE Ratings further analyses the impact of changes in key variables on solvency margin to ascertain the strength of the insurer. Apart from the above, CARE Ratings also assesses the current as well as potential underwriting capacity through an analysis of a firm's Operating Leverage.

Reserving Policy

CARE Ratings would study the reserving policy of the insurer and would examine the claims experience vis-à-vis the reserves created. The shortfall in reserves, if any, would then be compared with the insurer's net worth.

Apart from relying on regulatory guidance on prescribed solvency levels, CARE Ratings would assess the capital adequacy of the insurer. CARE Ratings believes that capital adequacy addresses the impact of all dimensions of risk in the long term and therefore helps in arriving at a realistic level of risk.

The description of various ratios considered by CARE Ratings can be found in the 'Financial Ratios – Insurance Sector' document available on its website www.careratings.com.

Rating of Insurance Hybrids

In 2015, IRDAI released guidelines on issue of other forms of capital for Indian insurance companies. Under this, insurance companies could raise capital through issuance of preference shares or subordinated debt to improve their solvency position. The subordinated debt issued by insurance companies has some unique features which are given due consideration while rating.

The rating of the Subordinated Debt of an insurance company takes into consideration its increased sensitivity to the insurers' solvency position and profitability during the tenure of the instruments. The rating factors in the additional risk arising due to the following key features of the instrument.

- Servicing of interest is conditional on the company maintaining a solvency above the levels stipulated by the regulator
- In case of the insurance company reporting a net loss or if the payment of coupon on the subordinate debt is expected to result in a net loss, the company requires obtaining a prior approval of the regulator for coupon payment on such sub debt

Any delay in payment of coupon/principal (as the case may be) would constitute an event of default as per CARE's definition of default and as such these instruments may exhibit a somewhat sharper migration of the rating compared to the issuer rating. Given these additional risks, subordinated debt of insurance companies is generally notched down by at least one notch from its issuer rating.

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