Rating Methodology - Insurance Sector

[Issued in August 2022]

Insurance industry:

The insurance industry is regulated by the 'Insurance Regulatory and Development Authority' (IRDAI) established in 1999 under the IRDAI Act. Being a highly regulated industry, the government's rules for the insurance industry play a key role in the company's performance besides the demand and supply trend. Furthermore, the industry dynamics like the demand for products, per capita income levels, competitive pressure, interest rate dynamics, and investment opportunities in the industry determine the business and financial profile of insurers in the industry.

Insurance reach is still low in India reflecting high growth potential. Overall insurance penetration for the life and non-life segment (premiums as a percentage of GDP) was 4.2% and 1.0% in the year ending March 2021 compared to the global average of 3.3% and 4.1% in the year ending December 2020, respectively. Insurance density for the life and non-life segment (measured as premium in USD to total population) is low for India at 59 and 19 in the year ending March 2021 compared with the global level of 360 and 449 in the year ending December 2020, providing a huge underserved market. The industry has received regular support from the government in increasing the insurance reach to the mass market. It has been regularly infusing equity to public sector insurers and is now also open for private funds to be invested in public sector insurers. It has also come up with favourable policies for the private sector. The industry has made Foreign Direct Investment (FDI) laws easier for the insurance sector, raising the FDI limit from 49% to 74%. The market share of the private sector in the non-life insurance industry has increased to 59% in FY22 from 56% in FY21, and in the life insurance industry (in terms of first-year premium) has increased to 37% in FY22 from 34% in FY21. The adoption of digital infrastructure in customer acquisition, claims processing and risk management is one of the key factors shaping the industry. Competitive intensity has further increased with the entry of Fintech players, who are redefining the customer experience through their user-centric, mobile solutions, on-the-spot purchasing, activation, and claims processing.

Background

CARE Ratings issuer rating for insurance sector companies is an opinion on an insurer's business and financial strength and measures its ability to honour policyholders' obligations and debt payments, if any, as per the contractual commitments. The opinion about policyholders' obligations is not specific to any insurance policy or contract and does not address the suitability of terms of any individual policy or contract. Additionally, the issuer rating neither considers deductibles, surrender or cancellation penalties nor does it account for the likelihood of the use of defence like fraud to deny claims. The rating also does not consider any limitation that the insurers might face in settling their foreign claims due to exchange of control sovereign restrictions that might be placed on foreign currency payments by the Government of India.

- The credit risk assessment of an insurer is the combined score of the various risks (business, financial risk, management, industry and regulatory environment) at a standalone level. These factors have been encapsulated under the 'RAMEL' framework, which is defined as below:

R Risk Underwritten

A Asset Quality

M Management

E Earnings

L Liquidity

S Solvency Margin

Risks underwritten

The analysis of risks underwritten constitutes a key element in an issuer rating assessment and plays a vital role in the outcome of the rating assigned. Improper pricing or high concentration against the risk underwritten may lead to significant claim pay-out for the insurer, which may impact its financial strength. The well-established, viable and diversified practice of underwriting risks enables the company to successfully sail through different business cycles and create value for all stakeholders. The efficacy of a firm's underwriting strength is assessed by its experience of historical claims, degree of diversification in the risks underwritten, and the relative growth in business volumes along with adequate maintenance of reserves against the risk underwritten. Also, large scale is one of the important factors in the analysis, which increases the insurer's capacity to absorb any abrupt high-claim pay-outs caused by any external shocks, compared to relatively smaller peers.

The following factors are considered while analysing the risk underwritten by the insurer:

- Market share and growth trends
- Embedded Value (for life insurance)
- Franchise strength and distribution channels
- Proportion of group / retail business
- 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
- Premium growth
- Annualized Premium Equivalent (for life insurance)
- Persistency (for life insurance) /Renewal (for non-life insurance) levels

For life insurers, different product segments have different levels of underwriting risks. For example, traditional insurance products like non-linked and non-participating product categories have a high risk for insurers than complex products like unit-linked products and variable-linked products, where the risk is transferred to the customers. Similarly, for the non-life insurer, some product categories have lower risk than others. IRDAI has provided the following risk classification for various general insurance products:

- High risk: Aviation
- Medium risk: Health, Liability, Motor
- Moderate risk: Marine Cargo, Others
- Low risk: Fire, Marine Hull, Engineering, Rural Insurance

A higher proportion of low-risk products is considered more favourable from the credit risk perspective.

Reserving policy

Maintaining adequate reserves is critical to avoid any unforeseen claim pay-out, which may deplete net worth and cause the insurer to come under the regulator’s surveillance. Inadequate reserving policy results in overstated reporting of profitability and capital adequacy. CARE Ratings would study the reserving policy of the insurer and would examine the claims experience vis-à-vis the reserves created across product categories by analysing past underwriting results and current underwriting practices to the industry standards.

Asset quality

The Issuer rating of an insurer could be hampered by future losses on its investment portfolio. In respect of the 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.

The insurance entities are susceptible to credit as well as market risk on their asset portfolio. In this regard, CARE Ratings analyses the quality and diversification of assets across various classes. CARE Ratings reviews the insurer’s level of adherence to regulatory norms and assesses its performance under specified constraints. CARE Ratings also measure the degree of success of the asset deployment strategy vis-à-vis the slated goals of maintaining a fair degree of liquidity, yield optimisation 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 non-performing assets (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. CARE Ratings looks at the management's mission, philosophy, business plans and targets, the experience of manning important positions, and degree of technology orientation. CARE Ratings' team undertakes discussions with key executives to understand the insurance companies' perspectives on the strategies and plans designed to counter various challenges within the organisation and industry. The experience and depth of management to tide over periods of crisis is recognised as a favourable attribute.

CARE Ratings also examines the financial strength and track record of the promoters, and the degree of group support enjoyed particularly at times of stress. Strong parentage and group support are viewed favourably by CARE Ratings and are examined with respect to the past proven support and assurances of future support.

Earnings

Profitable operations are necessary for insurance companies to operate as a going concern.
Insurers incur losses at the underwriting level in their initial year of operations. Achieving a break even in the initial year of operations and sustaining profit margins, thereafter, is of key importance to the credit risk. A good score on profitability reflects the sustainability of the business model adopted, including various factors like effective product pricing to cover risk, effective risk management practices in place and optimum technological investments to achieve economies of scale.

CARE Ratings 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 analyses the profitability of the underwriting and investment functions separately.

Underwriting profitability is impacted by the level of premium income, agency commission, staff costs and claims experience. The key expenses for underwriting are regulated as per the percentage of net premium income and higher-than-allowed expenses are analysed for their impact on the profitability and credit profile.

The following ratios are analysed to gauge the underwriting performance of an insurer:

- Loss/Claims ratio
- Expense ratio
- Combined ratio
- Value of new business margin (for life insurance)
- Return on embedded value (for life insurance)

The investment income is largely a function of the investment strategy followed by the company. The behaviour 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 are also examined.

- Investment yield
- Operating ratio

CARE Ratings analyses the level and trend of the below-mentioned ratios to assess the overall profitability of the insurer. These ratios are analysed 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 policyholders' 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 the untimely sale of investments, which may result in substantial realised losses due to temporary market conditions and/or tax consequences.

Asset liability maturity (ALM) analysis is one of the key factors in the assessment of liquidity, especially for a life insurer, given their staggering policyholder liabilities imbibed with options of surrenders and bonus payment to policyholders. Policyholder liabilities of life insurers are further impacted by their high sensitivity (due to long tenure) to changes in the mortality rates, medical inflation rates and interest rate movements. Furthermore, the complexity of the liability structure is increased, given the complex nature of the product like linked/non-linked, participating/non-participating, variable, life/pension/annuity, etc. The company's ability to match such liability structure with corresponding investment profiles in different stress scenarios is of key importance in the assessment of the liquidity of the life insurer. Furthermore, the liquidity of a life insurer is assessed as the sufficiency of liquid assets to cover the expected pay-out of policyholder liabilities and debt obligations over the next one year.

The non-life insurer has a relatively shorter tenure of policyholder liabilities compared to life insurers. The liquidity of a non-life insurer is assessed as the availability of liquid assets against technical reserves (comprising unexpired risk, claims outstanding, incurred but not reported liabilities).

Effective management of catastrophic event risk, through reinsurance or maintaining reserves, is of key importance in the assessment of an insurer's liquidity and financial flexibility.

Solvency

The solvency reflects the availability of capital, relative to the quantum of risk underwritten, to absorb any unforeseen losses and capacity to underwrite new business. This is to be maintained above 1.5x (150%) as per the regulatory requirement. The higher the ratio, the more favourable the insurer is assessed on the capital adequacy levels. Various factors which can impact the solvency ratio negatively are as follows:

- Significant growth in product categories having a high risk of claim pay-out and thereby increasing the quantum of risk underwriting. A higher claim ratio in future years from these product categories will translate into a decline in surplus generated from the operations.
- Realisation of losses on investment portfolio resulting in a decline in the surplus available to cover the risk.
- Inadequacy of reserves made against the risk underwritten. Inadequate reserves are adjusted to net worth

to analyse the impact of higher-than-expected claim pay-out on solvency levels.

- Increase in the regulatory reserve requirement for a segment/product category.

Apart from relying on regulatory guidance on prescribed solvency levels, CARE Ratings would also assess the capital adequacy of the insurer through other parameters. For the non-life insurer, the key metric to analyse the capital adequacy ratios is operating leverage. The ratio reflects the net premium written by a non-life insurer relative to the net worth. Given that the risk covered by a non-life insurer is of short term, the net premium written reflects the quantum of risk underwritten by a non-life insurer, which is then compared with the net worth. A higher ratio reflects the insurers' high-risk appetite to underwrite risk for a given net worth level.

Given that the life insurer underwrites risk for a longer tenure and has higher complexity in terms of the period of premium paid and risk covered, comparing business underwritten in one year to the net worth would not give adequate results. Accordingly, for life insurers, ratio of total assets/net worth is more appropriate, which reflects the leverage opted by the insurer. A higher ratio reflects more risk-taking appetite, and thereby, more risk underwritten for a given net worth level.

Reinsurance is one of the tactics used by insurers to lower their capital requirement for the underwriting risk underwritten. Also, the insurer opts for reinsurance for losses incurred in a catastrophic event, to cover the risk of unforeseen losses. CARE Ratings also examines the insurer's reinsurance programme, terms of reinsurance, the financial strength of reinsurers and the company's processes employed to monitor, collect, and settle outstanding reinsurance receivables.

External support:

While the standalone rating is 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 analysed 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 (JVs) driven by JV partners. Apart from this, the 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 Ratings' Criteria on Consolidation and Factoring linkages in ratings on our website www.careedge.in.

Rating of insurance hybrid capital

In 2015, IRDAI released guidelines on the issue of preference shares and subordinated debt (together referred to as hybrid capital) by Indian insurance companies. Before this, there was no source of raising capital other than equity. The key terms of hybrid capital are as per the below guidelines:

Particular	Conditions on Hybrid Capital
Quantum to be raised	Less than 25% of paid-up capital and 50% of net worth
Interest/Dividend rate	Interest and dividends paid can be fixed/floating. The floating rate is to be concerning the market-determined rupee interest benchmark rate.
Claim priority	The hybrid capital has seniority of claim to the claims of shareholders but is subordinate to the claims of policyholders and other creditors. The subordinate debt has a superior claim to preference shares.

<table>
<tr><td>Tenure</td><td>Not less than 10 years for life, general and reinsurance companies; not less than seven years for health insurance companies.</td></tr>
<tr><td>Security</td><td>Unsecured. No arrangement (including a guarantee from an insurer) should enhance the seniority of claims against the claims of policyholders and other creditors.</td></tr>
<tr><td>Servicing of interest/dividend</td><td>Interest on subordinated debt shall be charged to the profit & loss account and dividend on preference shares shall be paid out of the distributable profit of the shareholders:
Provided that the solvency of the insurer remains as per the regulatory stipulations.
Provided that where the impact of such payment may result in net loss or increase the net loss, prior approval of the authority for such payment shall be obtained.</td></tr>
<tr><td>Option</td><td>No put option to be imbibed.
The call option can be imbibed with a trigger date after a period of at least five years from the date of issuance.
No incentive to be imbibed for early redemption.
The exercise of a call option is subject to IRDAI approval and meeting solvency requirements.</td></tr>
<tr><td>Cumulative/Non-cumulative</td><td>The issuer may provide (not obligated to) missed interest payment in subsequent year, with/without compounding, subject to IRDAI approval.
The dividend payment on preference share is non-cumulative.</td></tr>
<tr><td>Dividend/Interest discretion</td><td>Cancellation of dividend/interest payment does not restrict insurer except for distribution of dividends to shareholders.</td></tr>
<tr><td>Inclusion in solvency levels</td><td>The hybrid capital can be included in the available solvency margin after applying hair cut in accordance with its years to maturity.
<table>
<tr><th>Years to maturity</th><th>Included in capital</th></tr>
<tr><td>5 years or more</td><td>100%</td></tr>
<tr><td>4 years and less than 5 years</td><td>80%</td></tr>
<tr><td>3 years and less than 4 years</td><td>60%</td></tr>
<tr><td>2 years and less than 3 years</td><td>40%</td></tr>
<tr><td>1 year and less than 2 years</td><td>20%</td></tr>
<tr><td>Less than 1 year</td><td>0%</td></tr>
</table></td></tr>
<tr><td>Debenture redemption reserve</td><td>Debenture redemption reserve is to be maintained (25% of outstanding debentures is considered adequate).
Debenture redemption reserve shall be ignored and not considered as a liability for computation of solvency margin and ratio.</td></tr>
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The rating of the hybrid capital of an insurance company takes into consideration its increased sensitivity to the insurers' solvency position and profitability during the tenure of the instruments. Any delay in the payment of coupon/principal (as the case may be), even if due to regulatory restriction, would constitute an event of default as per CARE Ratings' definition of default, and as such, these instruments may exhibit a somewhat sharper migration of the rating compared to the issuer rating. Also, the claimed priority of hybrid capital is subordinate to that of policyholders and other creditors. Given these additional risks, the hybrid capital of insurance companies is generally notched down from its issuer rating.

[For the previous version please refer to 'Rating Methodology – Insurance Sector' issued in July 2020**]**

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About:

CareEdge (earlier known as CARE Group) is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics capability and detailed research methods. CareEdge Ratings is one of the leading credit rating agencies in India. It has an impressive track record of rating companies for almost three decades and has played a pivotal role in developing the corporate debt market in India. CareEdge provides near real time research on all domestic and global economic developments. The wholly owned subsidiaries include CareEdge Advisory & Research arm focused on providing advisory and consultancy services and CareEdge Risk solutions a platform that provides risk management solutions