

Rating Methodology & Financial Ratios - Life Insurance Sector

[Issued in March 2025]

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, regulatory developments for the insurance industry play a key role in the company's performance besides the demand and supply trend. The industry dynamics, including the demand for products, per capita income levels, competitive pressure, interest rate dynamics, and investment opportunities in the industry determine the business and financial profiles of insurers in the industry.

Background

CARE Ratings Limited's (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, 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. The issuer rating neither considers deductibles, surrender, or cancellation penalties nor does it consider the potential use of defence, such as 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.

Credit Risk Assessment

- The credit risk assessment of an insurer considers analysis of business, financial risk, management, industry, and regulatory environment on a standalone level. These factors have been encapsulated under the 'RAMELS' framework, which is outlined as below:



Apart from aforementioned standalone credit assessment, factors such as industry and regulatory dynamics are also considered. CARE Ratings factors in the parentage of the insurer. Parental support is instrumental not only

from the point of view of capital support but also from perspective of access to distribution partnerships, thereby enabling business growth.

1. Risks underwritten

The analysis of risks underwritten constitutes a key element in the credit risk 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, ability to adequately price risks, degree of diversification (product/ geography) in the risks underwritten, and the relative growth in business volumes and adequate maintenance of reserves against the risk underwritten. 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 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 against peers
- Growth trends in new business premium & annualised premium equivalent
- Persistency trends across cohorts
- Value of new business & embedded value
- Franchise strength and distribution channels
- Proportion of group / retail business
- Geographical spread
- Diversity of the risks underwritten
- Product mix & pricing policy
- Underwriting expertise & performance
- Competitive advantages
- Product innovation

Life insurance companies broadly provide policies under the following segments:

- Protection (including term insurance)
- Savings (including participating, non-participating, and unit linked insurance policies or ULIPs)

2. Asset quality

The Issuer rating of an insurer could be hampered by future losses on its investment portfolio. In case of insurance entities, asset quality assumes a greater dimension as it influences the level of income and has a direct bearing on the insurer's ability to provide instant liquidity.

The insurance entities are susceptible to credit and market risks on their asset portfolio. In this regard, CARE Ratings analyses the quality and diversification of assets across various classes, and further reviews the insurer's level of adherence to regulatory norms and assesses its performance under specified

constraints. CARE Ratings also measures the degree of success of the asset deployment strategy against 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 against the insurer's risk profile
- Investment 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

3. Management

Management quality is an important qualitative aspect, which can make a substantial difference to a company's performance. CARE Ratings assesses 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 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.

4. 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 factors such as 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 per the percentage of net premium income and higher-than-allowed expenses are analysed for their impact on the profitability and credit profile.

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 performance of investment operations in terms of investment yield. Market risk and its probable impact on earnings are also examined.

CARE Ratings analyses the level and trend of the below-mentioned ratios to assess the overall profitability of the insurer. These ratios are analysed in the last few years and compared to the industry peers.

Following are ratios used for analysing earnings of Life Insurance companies:

Ratio	Formula	Significance in Analysis
Growth		
Gross Direct Premium (GDP) growth	$(\text{Current year GDP} - \text{Previous year GDP}) / \text{Previous year GDP}$	Indicates growth in business undertaken by an insurance entity.
Net Premium Earned (NPE) growth	$(\text{Current year GDP} - \text{Previous year GDP}) / \text{Previous year NPE}$	Indicates growth in business undertaken after ceding and accepting reinsurance by an insurance entity.
New Business Premium (NBP) growth	$(\text{Current year NBP} - \text{Previous year NBP}) / \text{Previous year NBP}$	Indicates growth in new business by a life insurance company excluding renewal premium
Annual Premium Equivalent (APE)	$(\text{Current year APE} - \text{Previous year APE}) / \text{Previous year APE}$	APE is the sum of annualised first year premiums on regular premium policies and 10% of single premiums underwritten during the period for both individual and group customers.
Business		
Risk retention	$\text{Net Premium Written (NPW)} / \text{Gross Premium Written (GPW)}$	Indicates the level of risks retained by the insurer against that ceded to the reinsurers. Reinsurance plays an essential role in diversification of risks.
Conservation Ratio	$\text{Renewal Premium collected} / (\text{PY first year premium} + \text{PY renewal premium})$	The ratio indicates the business generated via renewals
Market Share	$\text{Premium generated by specific company} / \text{Total premium generated in the industry}$	The market share shows the position of a company against peers
Profitability		
Expense ratio / Expense of Management ratio	$\text{Management expenses (including opex and commission)} / \text{GDP}$	The ratio measures the company's operating expenses and commission expenses as a proportion of premium

Ratio	Formula	Significance in Analysis
		income earned during the year. The expense ratio reflects the efficiency of insurance operations
Value for New Business (VNB) Margin	$VNB / \text{Annualised premium equivalent (APE)}$	VNB provides a measure of future profits for the new business written during the year.
Investment yield	$\text{Total investment income} / \text{Average total investments}$	This ratio measures the average return on the company's invested assets (including and excluding capital gains).
Persistency Ratio	$\text{Number of clients paying the premium (in X months)} / \text{Net Active Clients} * 100.$	The ratio indicates the business that the company is able to retain and generate renewal premiums across time cohorts
Net earnings ratio	$\text{Profit after tax (PAT)} / \text{Net premium written (NPW)}$	This ratio measures the overall profitability (after factoring in underwriting result, operating expenses and investment income and tax) of an insurer against net premium written.
Return on net worth	$PAT / \text{Average net worth}$	This ratio reflects the post-tax return generated on the net worth of an insurer. It is a measure of the overall return on the equity deployed in the business.
Return on assets	$PAT / \text{Average assets}$	This ratio reflects the post-tax return generated on the average total assets of an insurer.

5. Liquidity

Healthy 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. 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, among others. 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. 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.

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.

The liquidity ratios considered by CARE Ratings are:

Ratio	Formula	Significance in Analysis
Liquidity Coverage	Cash & cash equivalent / Technical Reserves ¹	This analysis showed the liquid funds available for a company against estimated claims payable.
Liquidity Coverage including sub-debt	(Liquid Investments + cash & cash equivalent) / (Technical Reserves + Sub-debt maturing in next one year including interest)	This analysis showed the liquid funds available for a company against estimated claims payable and debt obligations

6. Solvency

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

- Significant growth in product categories having a high risk of claim pay-out and 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 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.

Given that the life insurer underwrites risk for a longer tenure and has higher complexity in terms 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.

¹ Technical Reserves for Life Insurance = Policy Liabilities + Funds for discounted policies + Provisions
 Technical Reserves for General Insurance = Reserves for Unexpired Risk + outstanding claims reserves

Reinsurance is one of the tactics used by insurers to lower their capital requirement for the underwriting risk underwritten. 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.

Following are the ratios used to analyse the solvency position:

Ratio	Formula	Significance in Analysis
Solvency ratio	Available Solvency Margin / Required Solvency Margin	Compliance with a minimum requirement of 1.5x and cushion available above the regulatory minimum is examined.
Operating leverage	NPW / Net-worth	The net premium written reflects the quantum of risk underwritten by an insurer, which is then compared to the net worth. A higher ratio reflects the insurers' high-risk appetite to underwrite risk for a given net worth level.
Financial Leverage	Subordinate Debt / Net-worth	The ratio indicates the amount of leverage company has used via debt over its net worth.

External support:

While the standalone credit risk assessment 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 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 credit risk assessment of an insurance company. 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, ratings of certain insurance companies, 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 'CARE Ratings' criteria on consolidation & combined approach' and 'Notching by Factoring Linkages in Ratings' in ratings on our website www.careratings.com.

Analysis of environmental, social, and governance risk factors:

In the last few years, environmental, social, and governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. Companies might have to incur operational or capital costs towards mitigating these risks. CARE Ratings analyses the impact of ESG risks on the credit profile of

an entity by assessing expected impact of these costs on future earnings/revenue/cash flows of entities. As appreciation of ESG risks increase, the company's ability to raise capital might be affected as higher scrutiny from investors in terms of ESG compliance will increase, especially for players raising funds from overseas markets.

Environment risk

Environmental risk is a critical factor in assessing credit risk, especially for sectors that have a significant environmental impact. Typically, life insurance sector is not directly exposed to environmental risks. However, through their risk exposure to insured company/entity, they have an indirect exposure to environmental risk. These indirect risks could affect the business' future cash flows and are therefore factored in the overall credit risk analysis.

Social risk

Social risk plays a prominent role in industries that are labour-or service-intensive, such as banking, financial services, and hospitality. In these sectors, factors such as employee policies, workplace conditions, and customer relationships are critical components of credit risk assessment. Social considerations include how a company manages its workforce, its corporate social responsibility practices, and its interactions with the community. Issues related to social risks can have a significant impact on a company's reputation and financial stability, influencing its credit risk profile.

Governance risk:

Governance risk refers to internal factors related to how a company is managed and controlled, which directly impacts safeguarding stakeholders' interests. Key governance parameters include transparency, adherence to applicable regulations, public disclosures, and costs associated with maintaining strong governance structures. Companies with strong governance practices are generally considered to have lower credit risks, as they are better equipped to handle regulatory challenges and protect investor interests. The governance framework is a vital aspect of credit risk assessment, ensuring long-term sustainability and compliance.

Rating of hybrid capital of insurance companies

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 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.
Tenure	Not less than 10 years for life, general and reinsurance companies; not less than seven years for health insurance companies.
Security	Unsecured. No arrangement (including a guarantee from an insurer) should enhance the seniority of claims against the claims of policyholders and other creditors.

Servicing of interest/dividend	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 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.														
Option	No put option to be imbibed. The call option can be imbibed with a trigger date after 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.														
Cumulative/Non-cumulative	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.														
Dividend/Interest discretion	Cancellation of dividend/interest payment does not restrict insurer except for distribution of dividends to shareholders.														
Inclusion in solvency levels	The hybrid capital can be included in the available solvency margin after applying hair cut in accordance with its years to maturity. <table border="1" data-bbox="459 1010 1305 1279"> <thead> <tr> <th>Years to maturity</th> <th>Included in capital</th> </tr> </thead> <tbody> <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> </tbody> </table>	Years to maturity	Included in capital	5 years or more	100%	4 years and less than 5 years	80%	3 years and less than 4 years	60%	2 years and less than 3 years	40%	1 year and less than 2 years	20%	Less than 1 year	0%
Years to maturity	Included in capital														
5 years or more	100%														
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3 years and less than 4 years	60%														
2 years and less than 3 years	40%														
1 year and less than 2 years	20%														
Less than 1 year	0%														
Debenture redemption reserve	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.														

The rating of the hybrid capital of an insurance company takes into consideration its increased sensitivity to the insurers' solvency position and profitability in 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 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. 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 [August 2022](#) and [Financial Ratios-Insurance Sector' issued in August 2022](#)]

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About:

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