



ICRA Rating Feature

Methodology for Rating Hybrid Instruments Issued by Insurance Companies

Overview

This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in October 2019.

Insurance companies in India have been allowed to raise other forms of capital, as per the notification issued by the Insurance Regulatory and Development Authority of India (IRDAI) on November 13, 2015. Under these guidelines, insurance companies can raise subordinated debt or preference shares (referred to as hybrid instruments) under other forms of capital. Earlier, domestic insurance companies were not allowed to raise any form of debt or hybrid instruments and had no funding options other than raising equity from shareholders.

Hybrid instruments help insurance companies support their capitalisation and improve their solvency margins as they are included while calculating the available assets for solvency margin. These instruments are quite similar to the Upper Tier II instruments issued by banks under the Basel II guidelines. These instruments cannot be serviced if the insurer's solvency margin (approach similar to the capital adequacy ratio of banks) falls below the minimum regulatory requirement. Additionally, the regulator's approval is required to service the instrument if the company reports a net loss.

The rating of hybrid instruments is typically notched down from the insurer's issuer rating¹ as the obligation to the policyholders is senior to the obligation to the creditors. The insurer's issuer rating, in addition to the standalone business and financial risk assessment, also takes into account its parentage, its strategic importance to the group, and the ability and willingness of the parent company to ensure that all regulatory requirements of the rated insurance company are met in a timely manner at all points in time. The notching down of the rating for the hybrid instrument would depend on the likelihood of these instruments not being serviced, which, in turn, would depend on the insurer's solvency levels and profitability. The notch down factors in the capital buffer over and above the regulatory minimum. Higher the likelihood of the debt servicing being skipped due to a breach of the regulatory thresholds, higher would be the notch down and vice versa. Moreover, given the lower seniority as well as the non-cumulative nature of preference shares, the extent of notch down for preference shares may be higher compared to subordinated debt.

¹ Refer to ICRA's website www.icra.in to see ICRA's methodology for determining the issuer rating of insurance companies.

Brief features of these instruments are provided below.

Features of other forms of capital

Qualification of instrument	Preference share or subordinated debt
Limits for raising other form of capital	Shall not exceed: a) 25% of total paid-up equity share capital and security premium; and b) 50% of net worth
Seniority of claims	Preference share – Superior to the claims of equity shareholders and subordinated to the claims of policyholders and all other creditors Subordinated debt – Superior to the claims of preference and equity shareholders and subordinated to the claims of policyholders and all other creditors
Tenure of instrument	Minimum of 10 years for general, life and reinsurance companies; minimum of 7 years for health insurance companies
Servicing of interest/dividend	Subject to: 1. The solvency ratio of the insurance company being above the minimum regulatory requirement (150%) 2. Such payment not resulting in the insurer's solvency ratio falling below or remaining below the minimum regulatory requirement 3. Prior approval of the authority to make such payment if the impact of servicing the obligation may result in net loss. 4. No loss-absorption features that could result in compulsory conversion to equity
Cumulative/non-cumulative	1. Coupon on subordinated debt may be allowed to be paid in subsequent financial years, subject to the compliance of the criteria required for regular servicing of interest/dividend 2. Insurers are allowed to pay compound interest on missed coupon payments on subordinated debt 3. Dividends on preference shares shall be non-cumulative
Options	Call option after at least 5 completed years and requires approval of IRDAI; solvency margin requirement to be met before as well as after the exercise of call option; no put option allowed
Dividend/Interest discretion	Cancellation of dividend distribution on preference shares or servicing of the subordinated debt must not impose restrictions on the insurer except for the distribution of dividend to equity shareholders
Amortisation of the instrument for computing solvency	100% of the amount included in the capital for computing available solvency margin (ASM) up to 5 years from the date of issuance; progressive haircut for the computation of ASM on a straight-line basis in the final five years to maturity

Risk associated with hybrid instruments

The major risk associated with the instrument is the non-servicing of the interest or principal or non-payment of the dividend in case the insurance company's solvency margin is below the required regulatory level. The following could lead to a decline in the solvency margin:

- » Higher growth in gross direct premiums, especially in segments where the net claims ratio is high, would require the setting aside of higher capital as reserves

- » Higher net claims ratios would result in deterioration in underwriting surplus and translate into net losses
- » Increase in regulatory reserve requirement for a segment/product
- » Inadequacy of technical reserves
- » Realised losses in the investment portfolio

ICRA's framework for rating hybrid instruments

ICRA assesses the issuer rating for an insurance company, which becomes the anchor rating for notching down the rating of the hybrid instrument. To arrive at the anchor rating, ICRA examines the industry dynamics, the regulatory environment, and the business fundamentals of the insurance company concerned, its competitive position within the industry, and its financial strength. A key element of ICRA's analysis is the evaluation of the financial strength of the promoter entity and its ability as well as willingness to bring in capital to fund the insurance company's growth, meet the regulatory solvency requirements and support the latter's financial profile. The analysis of the insurance company's business fundamentals focuses primarily on its franchise strength, management, organisational structure, and underwriting and reinsurance strategies. The analysis of the insurance company's financial risk involves the assessment of key indicators, including profitability, liquidity, operating and financial leverage, capital adequacy, and asset/liability management. For more details, readers may refer to ICRA's published methodology to assess the issuer rating of life insurance and general insurance companies, available on ICRA's website www.icra.in

To arrive at the rating of hybrid instruments – in other words, to determine the extent of notching from the anchor rating – the following parameters are analysed:

- » Company's policy of keeping a buffer over the minimum required solvency margin and the historical track record of the same
- » Financial strength and flexibility of the promoter to bring in fresh capital
- » Size and liquidity of the investments (factoring in the fair value of investments)
- » Size of the distributable reserves in case of preference share rating to ascertain their adequacy to service dividends

Summing up

The rating approach involves the quantitative as well as qualitative assessment of credit issues. With the hybrid instrument obligations being subordinated to the policyholder's claim, the rating for the subordinated instruments can, at best, match the Issuer Rating of the insurance company. The notch down of the hybrid instrument would depend on the buffer over the minimum solvency level, financial strength of the sponsor companies, and the willingness/past instances of the parent company with respect to equity injection.



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