ICRA

RATING METHODOLOGY

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ICRA Rating Feature

Issuer Rating Methodology for Life Insurance Companies

Overview

ICRA's Issuer Ratings (IRs) for life insurance companies are opinions on their relative ability to pay policy-holder obligations in a timely manner. The rating essentially reflects the financial strength of the insurance company which also factors-in the ability and the strength of the sponsors to support the insurance company. ICRA also has a separate methodology for rating hybrid instruments issued by insurance companies available on its website www.icra.in.

Industry Structure

The Indian Insurance industry as we see it today, recorded a significant growth and saw introduction of various products primarily after the liberalization period, prior to which it was comprised of only the state insurance players, namely, Life Insurance Corporation of India and General Insurance Corporation of India. By the end of Q1 FY2019, the industry consisted of a total of 57 insurance players, wherein 24 are life insurance companies and 33 are general (non-life including specialized insurers) insurance companies.

The Indian Life Insurance industry has 24 companies, including Life Insurance Corporation of India. LIC accounts for ~63% of the new business premium generated in H1FY2020, or 72% of total gross premium. The top 3 private players (SBI Life Insurance Company Limited, ICICI Prudential Life Insurance Company Limited, and HDFC Standard Life Insurance Company Limited) accounts for another 20% of market share of the new business premium generated.

Typically, a life insurance company would be providing policies under the following segments:

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

Rating Methodology

ICRA's methodology to rating life insurance companies involves a comprehensive analysis of industry dynamics, the regulatory environment, the company's franchise and competitive position, and its financial position. ICRA's IRs are the culmination of an analytical process that involves working on:

Business risk drivers

- Industry dynamics
- Regulatory environment,
- Business fundamentals (including market ranking)
- Reinsurance strategies

Financial risk drivers

- Profitability
- Solvency and Capitalisation
- Liquidity and asset liability management
- Investment performance

Management Quality and Ownership Assessment

Parentage

Business Risk Assessment

Industry Analysis

Industry dynamics have a significant impact on a life insurance company's operating position and the product, market and pricing strategies available to a company and eventually have a bearing on the industry's and company's long-term core profitability. Some of the factors that affect the business prospects for life insurance companies are demographic characteristics, consumer behaviour towards long-term savings and retirement planning, the social security systems (or the lack thereof), and the overall regulatory framework. industry and firm level competition have a major impact on pricing and profitability.

Though life insurance companies essentially provide mortality protection, the nature of products offered by them encompass savings and investment related products, which put them in competition with other financial intermediaries such as asset management companies, pension funds and entities offering other long-term saving products. One direct implication of the competition has been the increasing complexity of insurance products as life insurance companies add various features and flexibilities into them. The competition among life insurance companies itself could lead to highly competitive pricing of life insurance policies, pressure to increase investment returns and higher selling costs. Regulatory policies and fiscal incentives such as tax benefits for insurance products also have an impact on the funds being channelled to life insurance companies.

ICRA evaluates the regulatory framework and the impact of evolving regulatory policy on the business prospects for the sector and the company being rated.

Operating Strengths and Business Franchise

The franchise that a life insurance company has is critical in determining its long-term business profile and eventually its core profitability. A company's franchise may arise out of its brand building efforts, its distribution strategy, and its ability to provide a basket of products to meet a range and varying needs of its customers. A favourable cost of operation is also a source of competitive advantage as it can drive the company's competitiveness in the insurance markets and its market share.

ICRA uses various indicators to evaluate a life insurance company's operating position. These include:

- Market position and share
- Distribution strength and cost (this includes analysing the channel business, its tie-ups, efficiency and quality of agency force and distribution channels)
- Underwriting and pricing experience (this includes analysing the company pricing its product for market share gain, or for profitability)
- Product mix, and ability to design, launch and manage new products
- Performance across various insurance product categories (this includes claims ratio, and persistency ratio vis-à-vis peers in the reported segments)
- Investment performance
- Claims settlement metrics and ageing of claims
- Operating efficiency and overall cost of operation

One of the critical factors affecting long-term performance of life insurance companies is persistency. Healthy levels of persistency not only indicate higher renewal premiums, but also a strong consumer franchise. The longer a policy stays in force, the more likely an insurer is to recover costs and make profit over the life of the contract. Companies with lower persistency levels relative to industry are viewed negatively as it may indicate customer dissatisfaction and low prospects of repeat business.

A strong business franchise would eventually lead to the company's strong market position, and its ability to generate growth, and hence would be a key determinant of core profitability and internal capital generation. Even as capital requirements are high in the initial phases of the life insurance companies, growth is an imperative not only to achieve market share, but also to achieve the requisite risk dispersion for insurance claims to be in line with expected claims.

A well-diversified life insurance product portfolio and a mix of income from insurance/risk products and investment income make for a strong operating profile and impart stability to the quality of the company's revenue and income stream. Comparison of the above indicators with peer group is a key part of the operating performance evaluation. Moreover, products need to be evaluated for risk mitigation and pricing adequacy, especially for guaranteed return schemes.

Reinsurance Strategy

Reinsurance is an important aspect of a life insurance company's risk mitigation programme. It is an effective means of protecting the insurer's capital and making capital available for future growth, especially in the initial phases when the demands on capital are high and risk dispersion yet to reach optimum levels. The reinsurance requirements of a life insurance company would depend on the product mix with term insurance products, especially for policies with large values of sum assured, typically requiring a larger reinsurance support.

ICRA's evaluation of a life insurance company's reinsurance programme would essentially focus on its reinsurance philosophy, its reinsurance partners, their credit quality and the re-insurers' track record in meeting obligations towards the life insurance company in the past.

Financial Risk Assessment

The main parameters that ICRA uses in assessing a life insurance company's financial position are its capitalisation, underwriting profitability, investment performance, as well as asset liability management and liquidity.

In its financial analysis of life insurance companies, ICRA uses various quantitative indicators and ratios. However, ICRA's financial and ratio analysis is not an exercise in isolation. A strong and a sustained financial profile is eventually an outcome of sustained operating and competitive strengths. Thus ICRA's financial analysis aims to evaluate how the financial position reflects or supports the business risk profile of the life insurance company.

Capitalisation

A company's capital position is among the most important determinant of its financial position and reflects its ability to generate sustainable growth and absorb any volatility in underwriting and investment result. The capital levels are also important from the statutory solvency requirements stipulated by the regulator. Strong capitalisation improves the company's ability to withstand financial stress and imparts it greater financial flexibility. Two key ratios that ICRA looks for evaluating capitalisation are the operating leverage, which is a ratio of the level of business that a company writes in relation to net worth and policy-holder surplus over total net worth. ICRA evaluates the capacity of the insurer to underwrite additional business without additional capital infusion (in relation to peers).

Financial leverage is measured by the level of subordinated debt as a percentage of net worth. Raising subordinate debt would help an insurer to shore up its solvency margin, thereby underwriting additional business. However, the interest payment would impact profitability.

Insurance companies are required to ensure that reserves are adequate to meet all future liabilities, which are determined on the basis of assumptions based on insurers' past experience, future expectations and with an appropriate margin for adverse deviations. The adequacy of such provisions needs to be evaluated carefully, especially in the light of regulatory changes in charge structure on products, which may alter the operating economics of distribution channels, lead to higher surrenders, slowdown new business and result in cost overruns.

Since policy-holder surplus and capital are computed on the basis of actuarial valuation of liabilities, ICRA takes into consideration the actuarial assumptions and also evaluates the impact of the key variables such as interest rate changes on the company's capital and its sensitivity to changes in these variables. While ratios are an important part of the quantitative analysis in the rating process, ICRA evaluates these ratios and the capital levels of a life insurance company against the backdrop of its business profile, its product mix, investment portfolio and asset quality, and the overall management strategy. An insurance company provides a range of products such as term insurance, with-profit policies, defined benefit policies and various unit linked plans. The requirement of capital to support these products varies with term insurance requiring relatively higher capital allocation while products such as with-profit policies would require a lower allocation. Products such as term insurance products and assured (guaranteed) return products are also highly sensitive to changes in the interest rates, which have been used in the pricing of the insurance products.

It should also be noted that the methodology note on rating of the subordinated debt of an insurance company is covered under the note titled, “Rating hybrid debt instruments issued by insurance companies”.

Profitability

Core and sustained profitability of an insurance company is a key indicator of its competitiveness and operating efficiency. A life insurance company’s profitability is a combination of its underwriting result and its investment income. ICRA evaluates both the underwriting result and the investment income and also looks at core profitability before capital gains and dividends paid out to policy-holders. Capital gains can often be volatile and may depend on temporary developments and not really reflect the company’s ability to generate returns on its investments. Since ICRA’s ratings are forward looking, in our analysis of the company’s profitability, we attempt to estimate the quality and sustainability of the future profitability under various scenarios based on the company’s business fundamentals which include its product mix, business franchise and its operating cost structure. Life insurers make losses in initial years because the income stream is spread over the policy term whereas the expenses pertaining to customer acquisition, infrastructure and marketing are front loaded. As the policy term progresses, life insurers recover various charges from policy-holder, which compensate for the upfront expenses/ cash outflow incurred by life insurance companies leading to higher net cash flows in the later years. From an accounting perspective, the commission and business acquisition expenses are charged up-front to the P&L account in the year they are incurred, thereby leading to accounting losses in initial years.

Historical profitability analysis helps to throw light on these aspects and can form a basis of discussion with management on past trends and their strategy in the future for sustaining or improving operating profitability.

The profitability ratios measured by ICRA to gauge profitability is provided in Annexure-1 (indicative list).

Investment Performance and Risks

An insurance company deploys policy-holder surpluses into investments, and investment returns are also factored in the pricing of insurance. Within the investment guidelines framed by the Insurance Regulatory Development Authority of India (IRDAI), individual companies construct their insurance portfolio to complement the insurance portfolio and liabilities, and reflecting its own risk appetite and its shareholder expectations. A key challenge in investment management is to invest in better yielding long-term assets without compromising on the asset quality and the liquidity of the portfolio. ICRA evaluates the broad investment strategy of the company in relation to the nature of the insurance liabilities that it has, with an emphasis on asset quality, portfolio diversification and the liquidity of the investment portfolio. ICRA also takes into consideration the historical performance of the investment division in order to get insights into how the division has been able to meet the investment and liquidity objectives of the company.

The key risks that the company’s investments are exposed to are credit risk, market risk and liquidity risk. Given the long-term nature of the insurance business’s liability profile and oftentimes the limited availability of assets/investments of similar maturities, the value of the company’s assets and liabilities can be significantly and differently affected by interest rate changes. Corporate debt also has significant credit risks driven by general economic conditions, regulatory policies and changing competitive pressures across industries. Equities too are exposed to significant market risks driven by the above factors besides volatile capital flows and a host of other issues. Given these risks, ICRA looks positively at a portfolio with a superior asset quality, and a portfolio diversified across various industries and asset classes/instruments (such as equities, Government securities, corporate debt, cash, etc).

Liquidity and Asset Liability Management

Asset liability management are procedures and systems adopted by the company to ensure that its assets and cash flows meet the maturing near term and long-term liabilities. A life insurance company writes insurance contracts for long periods and these contracts also provide for surrender, loans and flexible premium options. The pricing of these contracts are also based on expected interest rates and inflation levels over these periods. Some key features in the evaluation of the investment portfolio include asset liability management, liquidity and the impact of changes in the economic scenario and macro-economic variables such as inflation and interest rates.

The increasing complexity and features being built into life insurance products has increased the importance of the asset liability management process in the life insurance business. Product design, investment management and asset liability management have become increasingly integrated. Thus, to prevent an adverse development in the asset liability position due to options provided in their policies, insurance companies are increasingly building controls such as surrender costs, higher incentives for the longevity of policies and so on.

The focus of ICRA's asset liability and liquidity analysis is to evaluate management's strategy to mitigate the impact on cash flows and profitability while honouring maturing liabilities, and the likely change in the expected maturity of liabilities due to changes in the economic environment and actuarial assumptions. ICRA computes the ratio of liquid assets to the potential policy liabilities and debt maturing in the next one year. ICRA also evaluates near term liquidity by assessing the maturity of near term liabilities, which can be met through maturing assets and expected cash flow from existing written business.

The liquidity ratio measured by ICRA to gauge liquidity is provided in Annexure-1 (indicative list).

Management Quality and Ownership Assessment

Management, Governance and Financial Reporting Quality

Evaluation of management quality is a critical factor in ICRA's rating approach. Among the various features that ICRA factors in evaluating management quality are management vision and strategy, the experience and past performance of its key management team, management's appetite for risk, and its risk management and control systems and processes. ICRA also notes the corporate governance practices, board composition (including representatives from the foreign partner), and board's strategy on capital infusion. ICRA believes that sound operational procedures and controls are important in the life insurance business and would be key to efficient customer service. ICRA also evaluates the organisational framework and the cost structure. An area of significant focus would be the accounting and reserving practices of the company. ICRA would look positively at a prudent and conservative approach in the making of actuarial assumptions and the robustness of the company's capital to likely changes in these assumptions. The past operating performance of the company would also be a parameter in the evaluation of management capabilities.

Parentage

Ownership and Financial Strength of Parent

ICRA's rating methodology for life insurance companies especially the ones in the private sector would factor in significantly the financial strength of the promoters and their strategic interest in the business. The life insurance business in its initial phases creates a substantial amount of strain on insurer's capital due to the business start-up costs, high initial marketing costs, and the reserve creation for meeting future policy-holder benefits. Thus a life insurance company needs regular infusion of capital to maintain the solvency requirements stipulated by the regulatory agencies and for meeting future business growth. ICRA evaluates the financial strength of the promoting entity, its sources of operating cash flows and commitments, its allocation of funds for the life insurance business, and the strategic significance of the life insurance business to it. ICRA's IRs for new life insurers or those in their initial and formative years are likely to be closely linked to the financial strength and credit quality of the parent company.

ICRA also notes that a favourable business franchise and operating position, especially for the new private sector entities, are more likely to sustain the strategic interest of the promoting companies and ensure ownership continuity and steady capital infusion.

The rating approach involves both quantitative and qualitative assessment of issues. ICRA obtains and analyse company provided data as well as information available from public sources. The process is highly interactive involving significant discussion with management to get insights into its strategy and risk appetite.

Consistent with our general approach to ratings, there exist no formulaic approach to arrive at the rating and the emphasis is on the qualitative assessment of issues over a mere quantitative approach.

Summing Up

ICRA's Issuer Ratings for Life Insurance Companies are a symbolic representation of its opinion on their relative ability to pay policy-holder obligations in a timely manner. This opinion is arrived at following a detailed evaluation of the insurer's business and financial risks, its competitive strengths, it's revenue generation ability and the solvency ratio.

Overall, ICRA has a more favourable opinion on insurance companies which have a strong market share, diversified distribution sources, and a strong underwriting model. ICRA also draws comfort on strong parentage, and adequate solvency margins. The rating is a function of the operational track record of the company, the firm's product strategy and experience of the management team. Insurance industry is a highly regulated industry in India, any material changes in the regulations would have a rapid cascading effect on the insurance company.

Annexure-1

Ratios analysed	Details
Capitalisation	
Operating leverage	Net Premium Written (NPW) / Total Net worth (TNW)
	Policy-holder surplus / Total Net worth
Financial leverage	Total subordinated debt / Total Net worth (TNW)
Profitability	
Commission ratio	Net commission / Net Premium Written
Retention ratio	Net Premium Written / Gross Premium Written
Operating Expense Ratio	Total operating expenses / Net Premium Written
Investment income Ratio	Income from Investments and Fees / Net Premium Written
13th month persistency	Persistency refers to the volume of business that a life insurance company is able to retain. Simply put, persistency = No. of Clients Paying the Premium (in X months) / Net Active Clients * 100.
61st month persistency	
Return on equity	Net income / Total Equity
Liquidity	
Liquidity coverage	(Investments after haircut + Cash and bank balance) / (Total Policyholder liabilities + Subordinated debt maturing in the next year+ Current liabilities)
Solvency	
Available Assets in Policy-holders' Fund:	
Less:	
Mathematical Reserves	
Other Liabilities	
Excess in Policy-holders' funds	
Available Assets in Shareholders Fund:	
Less:	
Other liabilities of shareholders' fund	
Excess in shareholders' funds	
Total ASM (Excess in Policy-holder's funds - Excess in Shareholders fund)	
Total RSM (Required Solvency Margin)	
Solvency Ratio (ASM/RSM)	

Annexure-2

Issuer Rating Scale for Life Insurance Companies

[ICRA]AAA Issuers with this rating are considered to have the highest degree of safety regarding timely servicing of policy-holder obligations.

[ICRA]AA Issuers with this rating are considered to have a high degree of safety regarding timely servicing of policy-holder obligations.

[ICRA]A Issuers with this rating are considered to have adequate degree of safety regarding timely servicing of policy-holder obligations.

[ICRA]BBB Issuers with this rating are considered to have moderate degree of safety regarding timely servicing of policy-holder obligations.

[ICRA]BB Issuers with this rating are considered to have moderate risk of failure in timely servicing of policy-holder obligations.

[ICRA]B Issuers with this rating are considered to have high risk of failure in timely servicing of policy-holder obligations.

[ICRA]C Issuers with this rating are considered to have very high risk of failure in timely servicing of policy-holder obligations.

[ICRA]D Issuers with this rating have already failed in or are expected to fail in timely servicing of policy-holder obligations.

Note: *For the rating categories [ICRA]AA through to [ICRA]C, the modifier + (plus) or – (minus) may be appended to the rating symbols to indicate their relative position within the rating categories concerned. Thus, the rating of [ICRA]AA+ is one notch higher than [ICRA]AA, while [ICRA]AA- is one notch lower than [ICRA]AA.*

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