ICRA

RATING METHODOLOGY – GENERAL INSURANCE

NOVEMBER 2022

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Table of Contents:

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This methodology document describes the analytical approach followed by ICRA to assign Issuer Ratings to General Insurance companies and supersedes the earlier version published in June 2020. While this revised version incorporates a few modifications, ICRA's overall analytical approach to rating general insurance companies remains materially similar. ICRA's Issuer Ratings for general insurance companies are an opinion on their ability to pay claims, and honour policy-holder obligations on time. In other words, an Issuer Rating is ICRA's opinion on the financial strength of the rated insurer, from a policy-holder's perspective. An Issuer Rating provides an anchor for determining the rating of the subordinated debt issued by a general insurance company[1].

Overview

The Indian Insurance industry has recorded a significant growth over the years and seen the entry of new players as well as introduction of various products after the liberalization period in March 2000. Prior to this, the industry comprised of only the state insurance players, namely, Life Insurance Corporation of India and General Insurance Corporation of India. The industry currently consists of over 50 insurance players, of which over 30 are general (non-life including specialized insurers) insurance companies, while others are life insurance companies.

The general insurance industry consists of the four public sector insurers, namely, New India Assurance Company Limited, United India Insurance Company, National Insurance Company Limited and Oriental Insurance Company Limited. There are 21 private insurance companies. In addition, there are two specialised public sector insurers namely Agriculture Insurance Company Ltd. for crop insurance and Export Credit Guarantee Corporation of India for credit insurance and five private sector insurers which underwrite policies exclusively in Health, Personal Accident and Travel insurance segments.

Typically, a general insurance company provides policies under the following segments:

- **Motor**
    - *Motor – Own damage*
    - *Motor – Third party liability*
- **Health**
- **Fire**
- **Engineering**
- **Crop**
- **Marine**
    - *Marine – Hull*
    - *Marine – Cargo*
- **Others**

1 *ICRA's methodology for rating hybrid instruments issued by insurance companies, published in June 2020, has been reviewed and subsumed with the methodologies for rating general insurance companies and life insurance companies.*

Industry Risk Assessment

- Industry dynamics
- Regulatory environment

Business Risk Assessment

- Market position
- Product and distribution strength
- Underwriting standards

Financial Risk-Assessment

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

Other Elements of Credit Risk Assessment

- Parentage
- Management Quality
- Assessment of Environmental, Social and Corporate Governance Risks

ICRA obtains and analyses the company-provided data as well as the information available from public sources. The process is interactive involving discussions with the management to get insights into its strategy and risk appetite. Consistent with ICRA's general approach to ratings, there exists no formulaic approach to arrive at the Issuer Rating of a general insurance company with emphasis being on both qualitative as well as quantitative considerations.

Industry Risk Assessment

Industry dynamics

The key factors that influence the profile of all the industry participants include degree of market share concentration within segments, pricing strategies of individual participants, barriers to entry, impact of economic conditions on the general insurance industry, underwriting performance of the various segments and the impact of change in regulatory policies on the sector in general.

For an industry view, ICRA measures the business growth of the industry as well as broader financial health parameters. The business growth is measured by the Gross direct premium income (GDPI) in the financial year for the general insurance industry. In addition, ICRA would also view the financial health of the industry. The parameters factored in the measurement of the financial health of the industry includes combined ratio, and profit after tax (PAT) over adjusted networth[2].

2 Adjusted networth excluding the fair value adjustments on the equity investments

Regulatory risks

ICRA evaluates the current regulatory environment, as well as impact of impending changes in regulations that could impact an insurer's competitive position or lead to a restructuring of the products/segments within the industry. In the past the regulator had stringent pricing regulations across various segments, this has now been reduced to Motor third party segment only. Besides the pricing, the regulator has a stringent regulation with respect to investments, and capitalization levels. The measurement of risk (in solvency calculations) has multipliers which are pre-defined. Any changes in those parameters could have a sizeable impact on the business of a general insurance entity.

Business Risk Assessment

Operating Strengths and Business Franchise

The assessment of an insurer's franchise strength focuses on its positioning within its marketplace, and other characteristics that can help it create value. ICRA specifically assesses the quality of the insurer's products and distribution channels. Moreover, ICRA examines whether the insurer has sustainable competitive advantages in its key lines of business and assesses its ability to utilise such advantages in new areas. This involves a detailed discussion with the management, and a qualitative assessment on the company's products, distribution strengths, and risk management.

The channel used by an insurance company to deliver its products, particularly for commodity lines of businesses, is another fundamental aspect of the company's business profile. For some insurers, the distribution strategy may be a source of competitive advantage, while for others, it would be to provide flexibility in pricing and management of business volumes (for e.g., if the sponsor of a general insurance company is a bank, it has easier access to the bank's customer base). ICRA views an insurer's control over its distribution system (as typically new product developments are built around the distribution channels), as an important indicator of its competitive advantage within its line of business.

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

» **Market position:** Market position and share of underwritten premium in the industry (including market share of gross domestic premium (GDP) and its movement). ICRA would be looking at the overall market share of the entity and would evaluate on the average of last three years. The ability of the insurance entity to manage a large portfolio consistently indicates an ability to draw in a steady state of new business and have time tested internal controls and processes.

» **Product and Distribution strength, diversity and cost.** ICRA would evaluate strength of the distribution channels, the diversification of channels (geographical, and partner diversification) and profitability of the channels. ICRA would do a relative comparison between the insurers on diversification of the distribution and link it to growth in business, and projected growth in business. ICRA would also analyse the product mix, and ability to design, launch and manage new products. The current and the future product mix. The product and distribution diversification would help in the event of any adverse market development or regulations for a particular segment or product.

» **Underwriting standards, and pricing:** These include analyzing whether the company's pricing is aimed at market share gain, or for profitability). ICRA would check on the risk selection parameters. Product pricing is evaluated against the product/segment profitability. A well tested underwriting process would limit losses due to claims.

» Performance across various insurance product lines and segments (including loss ratio vis-à-vis peers in the reported segments)

» Claims settlement metrics and claims ageing analysis. Fraud mitigation processes, and user complaints metrics. As a principal the speed of claims processing and the severity of an insurance entity repudiating a claim is an important metric which end users evaluate before buying an insurance policy.

A well-diversified general insurance product portfolio across motor, fire & engineering, health, crop and other miscellaneous segments makes for a strong operating profile and imparts stability to the company's revenues. A comparison of the above indicators with the peer group is a key part of the operating performance evaluation.

For general insurance, the overall business risk is driven by the segment and product mix. The product suite of general insurance companies typically comprises of the following nine segments— fire, engineering, marine, aviation, motor, health, crop, liability and other miscellaneous segments. Each of these segments has a different risk profile. Insurance Regulatory & Development Authority India (IRDAI) has prescribed a ranking order for the segments in terms of their relative risk profile which is as follows:

Business segment	Risk category
Fire	Medium
Engineering	Medium
Crop	Medium
Marine-Hull	Medium
Marine-Cargo	Medium to high
Health	Medium to high
Liability	Medium to high
Motor	High
Aviation	High

These parameters are further analysed in detail in the financial assessment, where the ICRA's assessment largely echoes the risk profile set out by IRDA. ICRA assesses the risk profile of various business segments in terms of concentration and their segmental underwriting performance.

Underwriting

The product pricing includes an insurer's cost of origination as well as probability of a claim arising during the lifetime of the product. Consequently, an insurer's premium rate monitoring process, as well as its underwriting process, is reviewed and evaluated, as part of the rating process. ICRA evaluates the different business segments within which the insurance company operates, by first reviewing the past underwriting results (analysing the loss ratios at each business level), and second by reviewing the current underwriting process that will determine the future profitability levels. ICRA also evaluates the larger commercial risks underwritten, and the risk policies / reinsurance treaties in place to monitor large exposures. The ability to ascertain the correct pricing to compensate for expected losses in the portfolio is a key determinant of underwriting and claim settlement risk.

Reinsurance Policy

Reinsurance plays an important role in reducing exposure to catastrophic risks and in enhancing an insurer's operating leverage. Quality of reinsurance is a key factor in this analysis. ICRA tries to assess the structure of the insurer's key reinsurance programmes in relation to the probable maximum loss estimates and past catastrophe experience. Assessing the quality of reinsurance recoverable is also an important part of ICRA's analysis of asset quality. This typically involves identifying both, reinsurers from whom the company has the largest receivables and those to whom it has significant exposures. A review of the credit worthiness of these reinsurers is made by reference to their international Financial Strength Ratings and by considering the prior payment experience.

Parameters	Strongly positioned	Weakly positioned
Investment book	Net NPAs / Networth lower than 1%.	Net NPAs / Networth more than 15%.
	Strong risk monitoring process, with periodic review of all investments	The entity had outsized credit losses in the past. The risk process and systems are below average compared to peers
Product & distribution strengths	Segment spread is even, with no segment comprising more than 35% of total business. The geographical spread is well distributed, the entity should have a well-diversified book with higher retail business.	Segment spread is concentrated, with one segment comprising more than 60% of total business. The geographical spread is region specific. The entity has a high concentrated corporate exposure
Underwriting standards and claims management	A robust underwriting and risk team for both retail and commercial products. The company leveraging technology for analytics on the larger base of retail products, For commercial portfolio, qualitative opinion on the risk mitigation factors taken by the entity (would include physical inspections of risks, reduction of concentrations in geography as well industries etc). Claims settlement ratios consistently better then industry average	Use of technology in analytical process is at the minimum. Claim settlement metrics below peers, with high repudiation of claims and investigative orders by the regulator on claims processes.
Market position	Average market share over last 3 years of at-least 5%	Average market share over last 3 years lower than 1.25%

Financial Risk Assessment

The main parameters that ICRA considers in assessing a general insurance company's financial position are its capitalisation, underwriting profitability, investment performance, operating expenses, asset liability management and liquidity. In its financial analysis of general insurance companies, ICRA evaluates the past and the likely trends in the above parameters. 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 general insurance company.

Capitalisation

Central to ICRA's assessment of financial strength of a general insurance company is an evaluation of both the operating as well as the financial leverage of the insurer and to determine how these affect its overall financial flexibility. The operating leverage for a general insurance company is measured in terms of the business volume generated relative to the insurer's net worth. While, the 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[3], thereby supporting the underwriting of additional business.

The operating leverage and financial leverage are captured through the insurer's solvency ratio. The solvency ratio is guided by the regulator, and measures the adequacy of the insurer's assets against the future potential obligations (policyholder claims). The solvency buffer is usually a function of an insurer's business mix, business volumes and quality of asset portfolio. The solvency ratio for an insurer captures the adequacy of the capital required against the risk underwritten (regulatory approach on the solvency calculation is detailed in the IRDAI document). ICRA looks at the sensitivity to solvency metrics in various scenarios as part of the capital analysis.

Capitalization metrics

[Indicative metrics[4], core solvency is calculated without subordinated debt]

Solvency
- **Strong:** Above 1.75 times
- **Weak:** Below 1.5 times

Core solvency
- **Strong:** Above 1.6 times
- **Weak:** Below 1.5 times

Profitability

The profitability of a general insurance company is driven by a number of factors, including:

- Market focus of the insurer
- Competitive dynamics in each market segment
- Operating costs
- Underwriting record and outlook
- Investment strategy

ICRA assesses each of these factors to reach an opinion on the insurer's expected long-run profitability, and the variability of the same vis-à-vis expectations. Besides, ICRA evaluates the product-wise underwriting profitability, which provides a good indication of the returns generated by the insurer's principal lines of business. Overall profitability of a general insurance company is a combination of its underwriting result and its investment income. ICRA also evaluates the core profitability before capital gains. Capital gains can often be volatile and may depend on temporary developments and not necessarily reflect the company's sustained ability to generate returns on its investments.

Historical profitability trends also provide the background for subsequent discussions with the insurer's management on the outlook for profitability in the principal business segments. An important objective of profitability analysis is to develop a view on the quality and sustainability of earnings, since these are key to the insurer's long-term solvency.

3 *As per regulations, a general insurance company can only raise subordinated debt, no other forms of borrowings is allowed.*

4 *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it .*

ICRA analyses the following ratios for profitability (indicative list, not exhaustive):

- Net claims ratio or loss ratio (net claims incurred / net premium earned)
- Expense ratio or management expense ratio (management expenses / net premium written)
- Commission ratio[5] (net commission expenses / net premium written)
- Combined ratio (net claims ratio + expense ratio + commission ratio)
- Investment income ratio (net investment income / net premium earned)
- Investment yields
- Return on equity

[Indicative metrics ,looked over the period of 3 years]

Parameters	Strongest	Weakest
Combined ratio	Less than 107%	Higher than 115%
Investment yields[6]	Higher than 7%	Lower than 6%
ROE (over 3 years)	Higher than 15%	Lower than 10%

Liquidity

Liquidity management for an insurance company is the set of procedures and systems adopted by the company to ensure that its assets and expected new business premium meet the expected maturing liabilities and claims. ICRA assesses the liquidity for policyholders' claims of general insurers based on the trends in net claims payments in relation to net new business premiums as well as the share of liquid investments (Government securities) in their investment book. To assess the liquidity for servicing the subordinated debt, ICRA assesses the debt servicing liability of the company in relation to its shareholders' investments only. In addition, liquidity assessment also factors in the sustainability of new business premium, the potential support/ dependence of the company on its shareholders for capital requirements in next few months, which could have an impact on liquidity.

Investment Performance and Risks

An insurance company deploys policyholder surpluses into investments, and investment returns are also factored in the pricing of insurance. Within the investment guidelines framed by IRDAI, individual companies construct their investment portfolio to supplement their expected claims payout, and earn investment returns (managing the credit and market risk). ICRA evaluates the broad investment policy 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 to assess how the division has been able to meet the investment objectives of the company.

The key risks that the company's investments are exposed to are credit risk, interest rate risk, market risk and liquidity risk. The valuation of debt securities including Government securities are susceptible to interest rate movements, despite the credit risk being low, the relative large size of the portfolio makes it important to monitor market and liquidity risks. Corporate debt tends to be exposed to relatively greater 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 factors. Given these risks, ICRA considers a portfolio with a superior asset quality or a portfolio diversified across various industries and asset classes/instruments (such as equities, Government securities, corporate debt, cash, etc) more favourably.

5 *Commissions and related expenses incurred for selling the policies*

6 *Yields on average investments excluding realized gains*

Other Elements of Credit Risk Assessment

Ownership and Financial Strength of Parent

The financial strength of an insurance company's parent could be an important driver of the general insurance company's credit rating. ICRA's approach also involves assessing the importance of the insurance company to the parent's group operating strategy. The ability of the parent and the strength of its linkages with the rated insurer could influence likelihood of financial support coming from the parent to enable the rated insurer to meet the policy-holder claims and debt obligations, particularly during periods of stress. A stronger parent would be better positioned to regularly infuse capital to the insurance subsidiary, both to support growth and maintain a healthy solvency.

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

Management Quality

Among the various features that ICRA factors in evaluating management quality are management's long-term strategy, the experience of its key management team, management's appetite for risk, and its risk management and control systems and processes. Discussions with the insurer's management also serve to highlight its views on products and markets on which the company intends to focus, its expectations of success therein, and its expectations on the growth and profitability trends in the company's principal lines of business. ICRA also evaluates the tenor of the senior management team in the company, as insurance business has a high gestation period. ICRA's analysis entails extensive interactions with an insurer's management which enables forming an opinion on the management's quality and growth aspirations. This assessment is critical and necessarily subjective and helps in assessing the ability of the management to respond to challenges.

ICRA believes that sound operational procedures and controls are important in the general insurance business and would be key to providing efficient customer service. ICRA also evaluates the organisational structure and the cost structure. An area of significant focus would be the accounting and reserving practices of the company. ICRA would favourably consider 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 is also a parameter in the evaluation of management capabilities.

Assessment of Environmental, Social and Governance Risks

The assessment of the Environmental, Social and Governance (ESG) risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity, with focus on aspects that can have a material impact on its credit quality. While the Environmental (E)& Social (S) risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally translate into pulling down the rating, but generally the ratings are not pushed up even when the ESG context is favourable.

Environmental and Social Risks

While undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction.

While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap. That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differ widely across sectors and entities. In some cases, while the E&S risks could be material, their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the future and hence these considerations do not necessarily weigh on the rating today with the expectation that by then they would possibly adapt themselves by realigning their business model.

While evaluating the E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks.

The general insurance sector is directly exposed to physical climate risks, as motor and property insurance claims would increase manifold in the event of a natural calamity or a natural disaster. The insurers also need to adapt to the changing consumer preferences from time to time, besides being heavily reliant on human capital. The insurance industry is heavily regulated, and has a strong focus on policy sales by direct and indirect channels. This is done to prevent mis-selling of insurance products. The Covid-19 pandemic is an example of social risk given its substantial implications on health and safety. The pandemic has resulted in a greater awareness amongst the population to get a medical insurance, thereby creating an increase in demand for the general insurance industry. However, the risk for the industry is in-appropriate pricing and not getting adequate re-insurance cover, which had resulted in manifold increase in claims from health insurance products.

Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices depending on the way its financial statements are reported, the level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense debt holders are also assessed.

Summing Up

ICRA's Issuer Ratings are a symbolic representation of its opinion on the is an opinion on the ability to pay claims, and honour policy-holder obligations on time. 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 vis-à-vis its debt servicing obligations.

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 from strong parentage, and adequate solvency margins. The rating is a function of the operational track record of the company, the entity'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 direct effect on the insurance company.

Annexure: Parameters

Ratios analysed	Details
Capitalisation	
Operating leverage	Net Premium Earned (NPE) / Total Net worth (TNW)
Financial leverage	Total subordinated debt / Total Net worth (TNW)
Profitability	
Retention ratio	Net Premium Earned / Gross Premium Written
Net claims ratio or loss ratio	Net Claims incurred / Net Premium earned
Expense ratio or management expense ratio	Management expenses / Net Premium Written
Commission ratio	Net Commission expenses / Net Premium written
Combined ratio	Net claims ratio + Expense ratio + Commission ratio
Investment income ratio	Net investment income / Net premium earned
Yield on investments	Yields on average investments excluding realised gains
Return on equity	Net income / Total Equity
Liquidity	
Technical reserves	Total Reserve for Unexpired Risk + Estimated Liability in Respect of Outstanding Claims
Liquidity coverage	(Investments after haircut + Cash and bank balance + Net due from insurance companies) / (Total technical reserve + Subordinated debt maturing in the next year)
Fair value change in investment portfolio	Fair value change of equity investments
Solvency	
	Policyholder's Funds
(A)	Available Assets (as per Form IRDAI-GI-TA)
	Less:
(B)	Current Liabilities as per Balance Sheet (BS)
)(C)	Provisions as per BS
(D)	Other Liabilities
(E)	**Excess in Policyholder's funds (A) - (B) - (C) - (D)**
	Shareholder's Funds
(F)	Available Assets
	Less:
(G)	Other Liabilities
(H)	Excess in Shareholder's funds (F) - (G)
(I)	**Total Available Solvency Margin or ASM (E+H)**
(J)	**Total Required Solvency Margin or RSM (details of which can be accessed at IRDAI website**
(K)	SOLVENCY RATIO (Total ASM/Total RSM)

Summary of Rating Factors and an Example to Illustrate the Key Building Blocks of a Credit Rating

Category	Sub-category	Strong	Comfortable	Adequate	Moderate	Weak
Operating and business risk	Internal risk/claims systems and controls					
	Management Quality & Experience					
	Industry dynamics					
	Product/segment/channel strength					
Financial Risk	Capitalization					
	Investment book					
	Profitability					
Liquidity indicator	Liquidity					
		Enhance		**Neutral**		**Hinder**
Does this factor enhance or hinder credit profile	Parent/Group support					
	Final Rating	**AAA / AA+ /AA**	**AA- / A+ /A**	**A-/ BBB+ /BBB**	**BBB-/BB+/BB**	**BB-/B/C category**

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by the Rating Committees based on both quantitative and qualitative considerations.

Annexure: Approach for Rating Hybrid Instruments Issued by Insurance Companies

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 rating 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 promoter group, and the ability and willingness of the parent 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.

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
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 rating of the 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 process involves the quantitative as well as qualitative assessment of credit issues. With the hybrid instrument obligations being subordinated to the policyholders' claim, the rating for the subordinated instruments can, at best, match the claims-paying ability 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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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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