

RATING METHODOLOGY – GENERAL INSURANCE

November 2024



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This rating methodology updates and supersedes ICRA's earlier methodology document on general insurance published in November 2022. This document does not include an exhaustive discussion of all the rating factors considered by ICRA but provides an overall perspective on the parameters that are usually the most important. While it provides an overview of the salient rating considerations, readers may refer to the other cross-sector methodologies¹ available on ICRA’s website for more details.

Overview

This methodology document covers ICRA’s approach to assessing the credit quality of general insurance companies. The initial section discusses the aspects covered to arrive at the standalone credit profile of the issuer. ICRA may notch up the standalone rating of the issuer, based on the expectation of implicit financial support from the parent or Group. This notched-up standalone credit rating, a reflection of the issuer rating of general insurance company, reflects an opinion on the ability to pay policyholders’ claims and obligations. The ratings for the subordinated debt (sub-debt) instruments, eligible for inclusion in capital ratios, could be notched down from the issuer rating as per the notching criteria discussed later in the document.

A broad list of the rating factors that ICRA assesses while analysing general insurance companies is covered in this note. While these do not necessarily represent an exhaustive set of the factors considered by ICRA for assigning credit ratings, these are intended to provide an overall perspective to lenders, investors and other market participants on the parameters that are usually considered the most important. The key factors considered in the credit analysis are:

Industry Risk Assessment

- Operating environment
- Regulatory environment

Business Risk Assessment

- Franchise
- Quality of management

Financial Risk Assessment

- Earnings strength & stability
- Capitalisation
- Risk & Retention
- Quality of investment book
- Liquidity

Ownership/Parentage

Assessment of ESG Risks

- Environmental and social risks
- Governance risks

¹ In various instances, ICRA’s analysis is guided by considerations that are not specific to a given sector but find relevance across sectors. Examples of such considerations include how parent or group support impacts an insurer’s rating, the approach to consolidation, the impact of structural features or explicit third-party support on an insurer’s rating, holding company methodology, and so on. Methodology documents that describe ICRA’s approach towards such cross-sector analytical considerations are available at ICRA’s website www.icra.in.

The general insurance industry consists of private insurers and public sector insurers (PSU insurers). Within private insurers, there are general insurance companies and standalone health insurers (underwrite policies exclusively in health, personal accident and travel insurance segments). 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. This methodology is applicable to the entire general insurance industry. Typically, a general insurance company provides policies under the following segments:

- **Motor**
 - *Motor – Own damage (OD)*
 - *Motor – Third party liability (TP)*
- **Health**
- **Fire**
- **Crop**
- **Engineering**
- **Marine**

Health, motor, fire and crop are the top four segments accounting for 39%, 33%, 9% and 7% of the overall gross domestic premium income (GDPI) in FY2024.

Industry Risk Assessment

Operating environment

The operating environment is one of the important parameters, which could affect an insurer's growth, underwriting performance and profitability. The general insurance industry in India has seen growth with the increase in penetration and an increase in the population. A rising awareness on health insurance augurs well for the growth of the industry. Further, increased automobile sales support the motor segment which is the other key segment for the industry. Economic development typically fosters high demand for insurance. On the other hand, increased competition leading to pricing pressures and increased catastrophic events would adversely weigh on the insurers' underwriting performance. Besides the above, the inflation level could drive the extent of claim payouts, and the current estimates of payout may turn out to be lower in a high inflationary environment, thereby impacting profitability. The capital markets activity or the prevailing interest rates drives the investment income and form a part of the evaluation of the operating environment.

Regulatory environment

ICRA evaluates the current regulatory environment as well as the evaluates the 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, there were stringent pricing regulations across various segments, which has now been reduced to the Motor-TP segment only. Besides the pricing, the regulator has thresholds pertaining to the commissions and expenses of an insurance company, which could drive the changes in business mix for the company. Further, there are regulations with respect to investments which also drives the composition of the investment book. The solvency requirement and measurement of risk (in solvency calculations) has multipliers on premium and claims, which are pre-defined by the regulator. These regulatory developments can potentially impact ICRA's assessment and outlook on the growth, profitability, and capitalisation, which are among the key drivers of the credit profile.

Business Risk Assessment

Franchise

The franchise strength of an insurer determines its capacity to grow while maintaining granularity (share of retail business in overall business) and diversity across product segments, geography and distribution channels, thereby providing stability to revenue and earnings. The franchise strength of an insurer could be evaluated in terms of its scale of operations/market share and its presence across various segments. The distribution network is a determinant of the insurer’s competitive positioning. A well-diversified distribution channel strengthens the business profile and offers opportunities for growth across segments.

The key aspects of franchise evaluation are discussed below:

- Market position:** An insurer’s scale of operations and its position in each significant segment vis-à-vis peers remain important parameters to assess business risk. Insurers with a strong market share in the larger segments of the industry are expected to benefit from a greater diversification of risk and benefit from operating leverage. Apart from the overall market position as measured by the market share in GDPI, ICRA favourably views a higher presence in the granular retail segment (motor and retail health). An established presence in these segments reflects the strength of the distribution franchise, diversification of risk and offers more stability to the overall business. While the initial costs for the retail segments are higher, however, as the scale expands, profitability also improves. Further, the retail segments are the key drivers for the growth in the general insurance industry. The other non-retail businesses (crop/group health/fire) could be large in terms of premium flows, however, given that these could be finely priced or competitively bid, the volatility in premium income and profitability could be high. A presence in the retail segments would be important for maintaining/improving the market position. ICRA monitors the growth in the GDPI of the insurer compared to the industry average and in relation to its base.
- Diversity of distribution network:** The extent of diversification of the distribution channel is an important indicator of the ability of the insurer to drive growth across product segments. A diversified presence across agency, bancassurance (banca) and direct channels could benefit an insurer from the perspective of pricing and reach to the retail customer segments. Insurers with bank promoters may have a good presence in the banca channel, however a very high reliance on parent-banca may not necessarily be a positive attribute, as it may expose the company to channel concentration risks.
- Geographical Diversification:** A diversified geographical presence and product offerings not only reduce concentration risk but also enhances the competitive position of an insurer. Geographical diversification also helps reduce the claims volatility especially pertaining to natural catastrophes.

Some of the key financial indicators for the assessment of the franchise are as under:

Assessment of franchise

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Market share in overall GDPI	≥6.5%	≤2.0%
Market share in retail Segments (Motor Total + Retail Health)	≥6.0%	≤2.0%
Share of premium from diversified channels (Premium from Individual Agents, Banca and Direct (excl. crop and govt. health) as % of Overall GDPI)	≥40%	≤20%
Share of top 3 states in GDPI	≤45%	≥65%

Quality of Management

ICRA’s assessment factors in the management’s long-term strategy, the experience of its key management team, management’s appetite for risk, and its risk management. ICRA’s analysis entails interactions with an insurer’s management, which enables forming an opinion on the management’s stance towards growth.

The following parameters are considered:

- **Management depth and breadth:** The presence of qualified and experienced professionals and the track record of a stable top management are positive factors. Business outcomes vis-à-vis the guidance provided by the insurer also become parameters for assessing the management profile. Managements with the ability to identify emerging risks and select the chosen areas of growth are considered favourably and vice versa.
- **Established policies:** Established policies on factors such as capital cushions vis-à-vis regulatory levels and calibrated growth are some positive attributes. The demonstrated track record of adhering to these policies reflects favourably on the management.
- **Strategy:** A well-laid out business plan with regular disclosures on strategy and progress on goal achievements are some positive factors.
- **Conservative reserving:** A prudent and conservative approach in the reserving for risk (especially in the long-tail Motor-TP segment) is a positive attribute. An indicator for the same would be the consistent track record of favourable experiences in the loss-reserving triangle in long-tail as well as overall loss-reserving triangles.
- **Quality of disclosures:** While there are various disclosures as part of regulatory requirements, disclosures beyond these through investor presentations, quality of financial reports, earnings calls etc. reflects favourably.

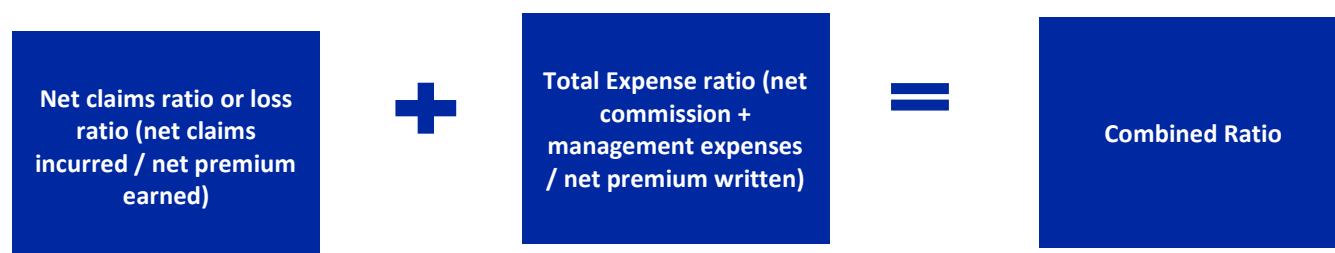
Financial Risk Assessment

Financial performance analysis is one of the key elements for comparing an insurer’s performance over a time period and across its peer group. ICRA conducts a detailed financial analysis of the insurer being rated on the parameters given below.

Earnings strength and stability

A general insurer’s ability to generate adequate returns is important from the perspective of its shareholders as well as debtholders. Adequate profitability provides the internal capital required for growth. The insurer’s historical performance is analysed for the stability and quality of earnings. The goal is to assess the level of the insurer’s future earnings and the quality/volatility of the earnings.

Insurer’s profitability involves the assessment of the underwriting performance and the investment income both of which are the drivers for the overall profitability. The underwriting performance gives an indication of the adequacy of the premium for meeting the claims and the expenses. Underwriting performance is evaluated using the net claims or net loss ratio and the expense ratio.



Both the net claims ratio and the expense ratio are viewed in conjunction. Given the high operating cost of distribution and servicing in retail segment, the claims ratio for this segment has to be lower when compared to wholesale segments (including group health). Hence the combined ratio is the indicator for the overall underwriting performance. However, while arriving at the premium to be charged for a given risk, the investment income on the float of investment book becomes an important component for the pricing and net profitability. The longer is the claim settlement period and the duration of the float enjoyed

by the company, the higher will be the investment income and ability of the insurance company to operate profitably even at higher combined ratio. As a result, the long tail Motor-TP segment could be highly profitable even at elevated combined ratio, while short-tail segment like retail health, which operate with much lower investment float will need to operate at much lower combined ratio to be profitable. The long-tail period for claim payout also results in higher reserving as such reserves are created without discounting for time payments to be made in future periods. Such long-tail payouts also exposes companies to uncertainties in terms of adequacy of reserving vs actual claim payouts in future.

ICRA evaluates the product-wise underwriting performance and profitability in conjunction with past claims experience from loss-reserving triangles, which provides a good indication of the returns generated by the insurer’s principal lines of business and likely future profitability. In addition to the company’s profitability, ICRA considers the volatility of its profitability, which refers to its ability to maintain profits across business cycles, to be an important parameter. An insurer with a well-diversified presence across product segments, consistently favourable claims experience by virtue of appropriate underwriting practices, is likely to achieve higher returns on equity and lower volatility in earnings.

Assessment of profitability

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Combined Ratio	≤ 97.0%	≥ 117.0%
Return on average networth (Past and Projected)	≥ 16.0%	≤ 9.0%

A high profitability translates in the generation of internal growth capital with limited dependence on shareholders for providing capital to fund the growth requirements.

Capitalisation

The solvency ratio of an insurer is a measure of the capitalisation. The solvency ratio indicates the size of capital of a company relative to the risk it has undertaken. IRDAI has laid down the guidelines for computation of the solvency ratio. It is measured as the Available Solvency Margin (ASM) divided by the Required Solvency Margin (RSM). The RSM is computed segment wise and is a function of either the premium or the claims for the segment (whichever is higher). Segments which have higher claims ratio have claim based RSM. The ASM is a function of the networth of the company. Apart from the networth, the IRDAI has allowed issuance of subordinated debt (sub-debt) instruments upto a specified limit which forms part of the ASM.

While evaluating the insurer’s capital in relation to the risks in its business, ICRA focuses on the following aspects:

- **Cushion over the regulatory capital requirement:** As per the IRDAI, an insurer is required to maintain a minimum solvency of 1.50x. ICRA assesses the capital cushion available over and above the regulatory requirement and the management’s stance on maintaining the same. A strong capital base supports the growth plans and also provides the necessary cushion against volatility in claim experience.
- **Adequacy and sustainability of capital:** Besides evaluating the insurer’s conformance to the regulatory capital requirements, ICRA assesses the adequacy of the capital in relation to its growth plans and its internal capital generation. Based on this, the insurer’s medium-term capital requirement is estimated.
- **Ability to raise capital:** The insurer’s capital cushions can be enhanced by internal capital generation or by raising fresh equity capital or subordinated debt. ICRA evaluates the headroom available to raise subordinated debt. For private insurers, the ability to raise capital from the market or the promoters is also factored in. For public insurers, the capital support announced by the Government of India (GoI) for the sector is an important aspect.

Assessment of capitalisation

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Core Solvency	≥ 2.10	≤ 1.40
Solvency	≥ 2.20	≤ 1.50
Capital requirement over next two years as % of existing ASM (excluding sub debt)	0%	$\geq 25\%$

Risk and retention

A major risk faced by an insurance company is the underwriting of the business at adequate premium pricing in relation to the underwritten risk. The uncertainty regarding the extent of claims is relatively higher in the Motor-TP segment, thereby exposing the company to reserving risks. The long-tail nature of the Motor-TP segment, given the legal process involved for claims settlement, could result in uncertainty regarding the level of future claims in relation to the past reserves made for this segment. ICRA assesses the company's loss-reserving triangle, which involves actuarial estimates, to see if it has maintained adequate reserves in the past. The claims experience in this segment is assessed vis-à-vis reserving during the past few years. Release from reserves until the claims experience emerges reflects a prudent measure. The eventual outcome for the risk-in-force for the Motor-TP segment may be known with considerable lag, which could impact the future profitability and solvency. Further, the profitability of this segment could be impacted as the pricing of Motor-TP rates is regulated.

The insurers have a reinsurance programme designed to ensure protection against exposure to large losses from single events and multiple losses from a single event (catastrophe). The insurer cedes a certain portion of its risks across segments to reinsurers by entering into reinsurance contracts. Depending on the granularity of the risk, the retention levels can vary significantly and hence the retention in retail segments could be higher compared to wholesale segments like fire insurance. Given the costs involved in reinsurance, the insurers try to achieve an optimum balance between extent of reinsurance and profitability. While higher retention of large-ticket risk can expose the insurer to claims risk, a natural catastrophe could lead to higher claims even when the risk is granular and diversified. Reinsurance is also used as a capital management strategy by the insurance companies and helps in increasing the capacity of the insurer to underwrite business. ICRA assesses the insurer's strategy on reinsurance and the maximum loss retention per event in relation to its network.

Assessment of risk and retention

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Share of long-tail business (Motor-TP) in GDPI	$\leq 15\%$	$\geq 35\%$
Retention as % of total GDPI (excluding crop insurance)	$\leq 65\%$	$\geq 85\%$
Maximum CAT loss per event for the insurance company as % of ASM (excluding sub-debt)	$\leq 0.5\%$	$\geq 1.5\%$

Quality of Investment Book

Till the claim payout, an insurer deploys policyholder premiums into investments, factoring in the return on these investments into the pricing of insurance. Within the investment guidelines framed by the IRDAI, individual companies construct their investment portfolio to align the maturity (debt instruments) of these investments with expected claims payout period to reduce liquidity risk and maximise investment income. The higher the share of long-tail businesses, longer will be the period of such investment book held by the insurance company and higher the size of investment book in relation to its net worth (also referred as investment leverage). ICRA evaluates the investment book with emphasis on asset quality, portfolio diversification and the liquidity of the investment portfolio. The key risks that the company's investments are exposed to are credit, interest rate, market and liquidity risk. The valuation of debt securities including Government securities are susceptible to interest rate movements. Despite the credit risk being low, the relatively large size of the portfolio makes it important to monitor market risks. As the companies will make their debt portfolio investments with the matching claim payment period,

the mark-to-market (MTM) gains/loss because of change in interest rates are not required to be recognised for profitability and solvency. However, if these debt instruments are required to be sold to generate liquidity in a scenario of inadequate new business or high claims, it may result in realised losses and could impact the profitability and solvency. Corporate debt tends to be exposed to relatively greater credit and liquidity risks. ICRA assesses the quality of the corporate debt basis the credit ratings and instances of asset quality issues. While the investment book largely comprises debt investments, a high share of equity portfolio may expose the capitalisation to volatility. In a business-as-usual scenario, the claims payment and operating costs are typically met through the new premium inflows.

ICRA considers a portfolio with high share of AAA/Government securities without any unrealised MTM losses favourably.

Liquidity

Liquidity management for an insurance company is to ensure that its expected new business premium and assets meet the policyholder claims and expected maturing liabilities of sub-debt. ICRA assesses the policyholders' liquidity based on the trends of net claims payments in relation to net premium written as well as share of liquid investments (Government securities) in their investment book. Generally, the operating cash flows of the insurer are expected to be positive after meeting the operating expenses, apart from the claim payments. 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.

Assessment of liquidity

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Net Premium Written in last year/Max net claims paid in last 3 years	≥ 3.0	≤ 1.0
Government and State Government Securities as % of Total investments	≥ 65%	≤ 45%
Shareholders' Investment / Sub-debt	≥ 6.0	≤ 3.0

Ownership/Parentage

The risk profile of an insurer, which is a part of a large corporate group or has an established promoter, can benefit from its strategic fit with the group or from the experience of the promoter. Moreover, companies backed by strong corporate groups or which have large institutions as strategic investors are expected to have adequate internal controls and processes and are, thus, expected to provide higher comfort. The insurer could also benefit with the promoter (bank or financial institution) sourcing business for the insurer. Over and above the standalone credit considerations, the likelihood of extraordinary support from the parent is factored in while assessing the insurer's credit profile. This process involves the assessment of the ability and willingness of the parent to extend support in times of distress in addition to the evaluation of the insurer's own fundamental credit strength. For PSU insurers, ICRA draws comfort from the sovereign ownership.

If the parent's/group's credit profile is weaker than the rated insurer, the insurer's rating may be lower than what its standalone credit profile assessment would have merited. This is due to the possibility that the insurer may, at some point of time, be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile².

² For more details, readers may refer to the documents titled, 'Rating Approach – Implicit Parent or Group Support', available on ICRA's website.

Assessing the Likelihood of Support from the Parent to the Rated Insurer

Parameter	Description		
Intent of support	<ul style="list-style-type: none"> Has the parent expressed its intent to extend support to the rated insurer, if required? Is there a track record of support ensuing from the parent to the rated insurer? 		
Reputation sensitivity	<ul style="list-style-type: none"> Does the support provider have a high reputation sensitivity and would it be willing to extend extraordinary support to the rated insurer when the latter faces stress? 		
Strategic importance	<ul style="list-style-type: none"> Is the rated insurer in a business segment that the parent considers to be a priority as it offers strong long-term strategic benefits in the form of business, product or geographical diversification? Does the rated insurer enhance the support provider’s franchise and/or competitive position? 		
LOW	MODERATE	HIGH	VERY HIGH

Assessment of ESG Risks

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

Environmental and social risks

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

While evaluating the E&S risks, ICRA’s objective is to assess the direct and indirect risks faced by an insurer and how it already is or is intending to mitigate the impact of such risks on its credit profile. The health, mortgage, and trade credit insurance business undertaken by an insurer faces low environmental risks, unlike property or asset insurance that is exposed to risks arising from natural or climate-change-related calamities. Such events do pose material risk of elevated claims, higher than those factored-in, that could adversely impact the financial performance. While the ability of insurers to reprice insurance policies on an annual basis somewhat mitigates this risk, the increasing incidences of catastrophic losses linked to climate change adds to the underwriting complexity. Climate change contributing to water shortage and droughts can also result in losses in the business relating to agricultural insurance, but this is just one among the other lines of business of an insurer and does not by itself contribute to pushing up the credit risk materially.

With regard to social risks, data security and customer privacy are among the key sources of vulnerability for insurers as material lapses could be detrimental to their reputation and could invite regulatory censure. ICRA evaluates the disclosures made by insurers outlining the key policies, processes, and investments made to control the occurrence of such instances. Mis-selling and other types of misconduct are other social risks that could result in fines and reputational harm.

Governance risks

A sound corporate governance structure attempts to clarify the distinction of power and responsibilities between the board of directors and the management. The constitution of an insurer's board and its adherence to legal and statutory compliance requirements are considered during the credit assessment. ICRA seeks to gain a qualitative understanding of the insurer's commitment to following transparent and credible practices from the way its financial statements are reported, the level of disclosures, consistency in communication and openness about sharing information during the credit rating exercise. Besides the corporate group structure (whether simple or complex), the rated insurer's related-party transactions and instances of supporting group entities at the expense of debtholders are assessed. Specifically, ICRA examines factors such as auditor qualifications, quality of disclosures, notes to accounts for evaluating the adequacy of accounting quality standards, and the internal audit process.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the insurer and the instruments being rated. ICRA arrives at this opinion by conducting a detailed evaluation of the insurer's business and financial risks and using the evaluation to project its future financial performance in various scenarios. While several parameters are used to assess an insurer's risk profile, the relative importance of each of these qualitative and quantitative parameters can vary across insurer depending on its potential to change the overall risk profile of the insurer concerned.

ICRA’s approach for rating hybrid instruments

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](#), which were subsequently updated in notification dated [December 06, 2022](#). 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.

Brief features of these instruments and the key changes in the new guidelines (December 2022) are as listed below:

	Earlier Regime (Nov 2015 guidelines)	New Regime (Dec 2022 guidelines)
Qualification of instrument	Preference share or subordinated debt	No change
Limits for raising other form of capital	Shall not exceed: a) 25% of total paid-up equity share capital and security premium; or b) 50% of net worth whichever is lower	Shall not exceed: a) 50% of total paid-up equity share capital and security premium; or b) 50% of net worth whichever is lower
Seniority of claims	Preference share – Senior to the claims of equity shareholders and subordinated to the claims of policyholders and all other creditors Subordinated debt – Senior to the claims of preference and equity shareholders and subordinated to the claims of policyholders and all other creditors	No change
Tenure of instrument	Minimum of 10 years for general insurers and 7 years for health insurance companies	No change
Servicing of interest/dividend	Subject to: <ul style="list-style-type: none"> The solvency ratio of the insurance company being above the minimum regulatory requirement (150%) Such payment not resulting in the insurer’s solvency ratio falling below or remaining below the minimum regulatory requirement Prior approval of the authority to make such payment if the impact of servicing the obligation may result in net loss. 	Prior approval of regulator required if: <ul style="list-style-type: none"> The solvency ratio of the insurance company is below the minimum regulatory requirement (1.50x) Such payment of interest or dividend would result in the insurer’s solvency ratio falling below or remaining below the minimum regulatory requirement The impact of servicing the obligation may result in net loss or increases the net loss.
Exercise of Call option	<ul style="list-style-type: none"> Call option after at least 5 completed years Solvency margin requirement to be met before as well as after the exercise of call option Prior approval of the regulator required before exercise of call option No put option allowed 	<ul style="list-style-type: none"> Call option after at least 5 completed years Solvency margin requirement to be met before as well as after the exercise of call option Insurer may exercise the call option without the prior approval of the Authority; prior approval required if after exercising such call option, the solvency position of insurer is not, at least 20% above the minimum regulatory requirement (i.e. 1.50x +20% of 1.50x = 1.80x) No put option allowed
Investment by an Insurer in “Other Forms of Capital” of another insurer	An Insurer may invest in the “Other forms of capital” issued by another Insurer	An Insurer may invest in the “Other Forms of Capital” issued by another Insurer subject to the following:

Earlier Regime (Nov 2015 guidelines)		New Regime (Dec 2022 guidelines)
		<ul style="list-style-type: none"> Such investments shall not qualify as an admissible asset for determining the Control Level of Solvency Insurer shall not invest in the Other Forms of Capital of another insurer having a common promoter.
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	No change
Amortisation of the instrument for computing solvency	Progressive haircut for the computation of ASM on a straight-line basis in the final five years to maturity	No change

Risk associated with hybrid instruments

Hybrid instruments help insurance companies support their capitalisation and add to 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 which were 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. As per the latest guidelines, prior approval of the regulator is required if solvency is below the regulatory requirement. However, given the dependency on the regulatory approval for payment of coupon if the solvency is below the regulatory requirements, solvency and capital buffers maintained continues to remain the key criteria for rating of sub-debt.

In a nutshell, the major risk associated with the instrument would be the insurance company’s solvency margin declining below the required regulatory level or the company incurring a net loss, which can constrain its ability to pay interest/dividend or redemption of the hybrid instruments.

ICRA’s framework for rating hybrid instruments

ICRA assesses the issuer rating for an insurance company, which is the reflection of the insurance company’s ability to pay the policyholders claims and obligations and this becomes basis for the anchor rating of the hybrid instrument. 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 rating of hybrid instruments is typically notched down from the insurer’s issuer rating as the obligation to the policyholder is senior to the obligation to the creditors. 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.

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 and the importance of the subsidiary to the promoter
- Size of the accumulated earnings or distributable reserves in case of ratings of preference share to ascertain their ability to service a dividend in a year of loss

Conclusion

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.

Annexure – Rating Framework

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a general insurer

Category	Sub-category	Strong	Comfortable	Adequate	Moderate	Weak									
Business Risk	Franchise														
	Quality of Management														
Financial Risk	Earnings Strength and Stability														
	Capitalisation														
	Risk and Retention														
	Quality of investment book														
	Liquidity														
		Superior	Strong	Adequate	Stretched	Poor									
		Very High			High		Moderate		Low						
Parent/Group Support	Likelihood of Parent Support														
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category
	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 Rating Committees based on both quantitative and qualitative considerations.

Contact us for any feedback or comments at: methodologies@icraindia.com

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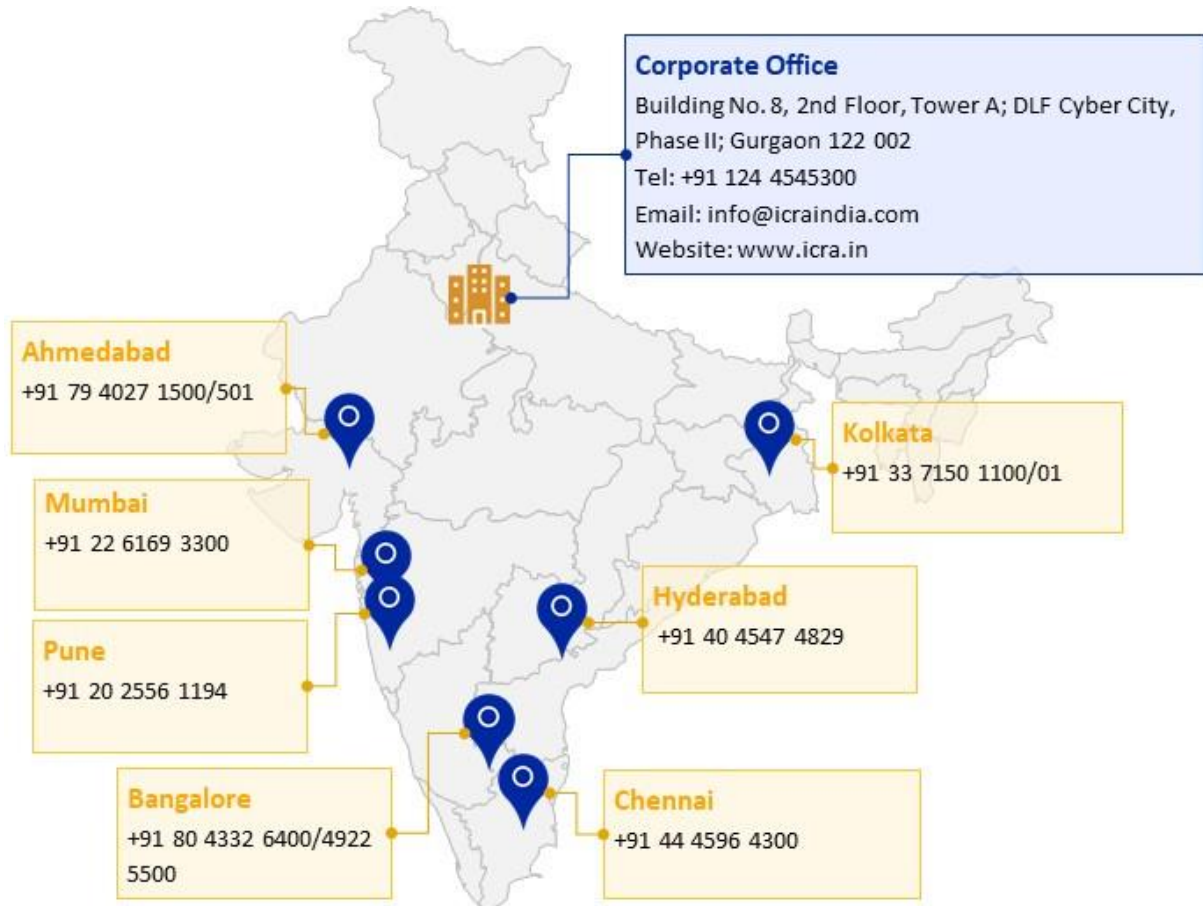


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