

Rating criteria for general insurance companies

June 2023

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Executive summary

CRISIL Ratings assigns corporate credit ratings (CCR) to insurers to measure their financial strength, i.e. their ability to meet policyholder obligations. The ratings methodology¹ for general or non-life insurance companies entails assessing them on a stand-alone basis and the level of parent support they receive. Apart from their financials, factors such as industry and business risks, risk management systems, goals and strategies, and projected business plans are analysed on a stand-alone basis. Parental support is especially crucial for start-up insurance ventures, given the need for recapitalisation till they break even and begin generating profits.

¹ Previous published document on 'Rating criteria for general insurance companies' may be found at: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/CRISIL-Ratings-criteria-general-insurance-companies-oct2022.pdf

Scope

This criteria document highlights the CRISIL Ratings approach to assessing the credit quality of general insurance companies. The methodology outlined in this document is used to arrive at the standalone rating of a general insurer. CRISIL Ratings may notch up the standalone rating for support from the parent / government. The extent of notch-up is driven by the criteria for notching up standalone ratings of entities based on parent / government support, which can be found on the CRISIL Ratings website, www.crisilratings.com. The document also covers CRISIL Ratings' approach to financial ratios used for analysing these entities.

Stand-alone assessment

Business risk

This includes factors specifically influencing a particular company:

Business mix and competitive position: The analysis focusses on the projected business plan to understand the firm's commitment to prudential underwriting standards. For non-life insurance companies, the overall business risk would be determined by the business mix comprising insurance for motor, health, crop, fire, marine, aviation, and miscellaneous segments. Each of these segments has a different risk profile.

As part of solvency computation, The Insurance Regulatory Development Authority of India (IRDAI) prescribes factors for each business segment in terms of their relative risk profile.

Business segment	Risk category
Fire	Medium
Engineering	Medium
Rural insurance	Medium
Marine - hull	Medium
Marine - cargo	Medium to high
Health	Medium to high
Liability	Medium to high
Crop	High
Motor	High
Aviation	High

CRISIL Ratings also assesses the risk profile of the various business segments and their impact on the company's overall underwriting performance. Additionally, CRISIL Ratings looks at the segment-wise claims ratio to assess the efficacy of underwriting performance across segments.

In the past decade, several mono-line insurers, particularly private health insurers, have emerged. Given their exposure to a single segment, CRISIL Ratings evaluates their expertise and track record keeping in mind the nuances of the sector.

The market share in each line of business and the key competitive advantages enjoyed is studied to assess the overall business strength of a non-life insurance company. Diversification mitigates risk, and hence, product and geographical diversification is evaluated. The overall insurance industry is also analysed based on its importance to the economy, present size and growth potential, entry barriers, stability of underwriting performance, and policies governing the sector. On the regulatory front, licensing requirements, investment guidelines, accounting norms, pricing freedom, and solvency margins are examined; all insurance companies need to comply with these regulations.

Underwriting policy: Sound underwriting guidelines are pivotal to an insurance company's long-term solvency. The analysis captures the management's policy with regard to underwriting, which could range from focusing on profitable underwriting backed by superior service and value-added risk management services, to offering competitive rates to grow business. Some of the parameters in this study are underwriting surplus (deficits), claims ratio and combined ratio. Claims ratio, measured as the ratio of net incurred claims to net premium earned, indicates the adequacy of pricing with regard to the underwriting risks inherent in the business. Underwriting surplus (deficits) is arrived at by deducting the sum of net claims incurred, net commission paid, and operating expense from net premium earned. And combined ratio is a factor of both claims and expenses.

Policy on reinsurance: Reinsurance helps to diversify the underwriting risk among a pool of reinsurers and increases an insurance company's underwriting capacity. It is critical for non-life companies in managing underwriting risks, as it not only enhances the underwriting capacity but also helps to cap the overall loss that could devolve on the primary insurer. CRISIL Ratings assesses the level of risk retained by the insurance company by studying its reinsurance strategies, the reinsurance programmes that have entered, the extent of reinsurance, and the financial strength and credit profile of the reinsurance companies. To assess the extent of retention, CRISIL Ratings assesses the reinsurance programme for each business segment (quota share, surplus, and facultative treaty), with the reinsurers. The analysis also captures the policy regarding sharing of claims in excess of the retention limit. Non-life companies enter into excess of loss (XL) covers and catastrophe excess of loss (cat XL) covers to limit the overall liability that devolves on the primary insurer arising from single events.

Investment policy and quality: A prudent management of the investment portfolio is critical to bolstering an insurance company's overall performance. Appropriate systems, prudent investment policies, and internal controls are important aspects of fund management. CRISIL Ratings examines the insurance company's investment strategy with regard to credit quality, capital appreciation, long-term safety and easy liquidity. The investment portfolio's diversification across industries and corporates and single risk concentration limits are important inputs in determining the overall asset quality.

Technology and risk management: Technology, both to support product delivery and manage risks, is critical.

CRISIL Ratings studies the company's risk management systems for both, monitoring risks and evolving reinsurance strategies. In terms of risk management, globally, insurance companies offer a range of services that include risk analysis, grading and control, hazard studies, safety audit, risk management training and insurance portfolio analysis. These services help corporate clients comply with statutory requirements, institute unified risk management policies, and ensure optimal insurance costs. Insurance companies that are able to offer these services can enhance their competitive strengths and grow successfully.

Besides its use in risk management, technology — particularly, information technology — has emerged as a critical mode of product dispersion, as several consumers shop for these products online. Further, comparison of insurance products on websites has increased pricing pressures and driven companies to lower their dependence on costly

manpower alone. And finally direct digital channel and use of digital means for customer onboarding and retention is also an important pre-requisite as customers are technology savvy and seek frictionless transactions.

Financial risk

CRISIL Ratings evaluates parameters such as fund infusion plans in line with business requirements, whether a company's solvency ratio complies with IRDAI's stipulations, and if the solvency margin is adequate. Further, the liquidity plan to meet policyholder obligations, accounting policies adopted, and the timeframe for breakeven (for new start-ups) are critically examined.

Capitalisation: IRDAI has prescribed a minimum start-up capital of Rs 1 billion for non-life insurance companies. To ensure the company's safety and financial health, it has prescribed a required solvency margin (RSM).

In addition to regulatory compliance, the analysis factors in the adequacy of the projected solvency margins. The solvency ratio, as measured by the available solvency margin/RSM, is a measure of adequacy of capital against the underwriting risks inherent in the business and growth of an insurance company.

In 2016, IRDAI allowed the issuance of hybrid instruments to supplement the capital requirements, thereby boosting the available solvency margin of several general insurers. This also ensures additional discipline in maintaining the solvency margin above regulatory minimum as payouts to these instruments are contingent upon this.

Though general insurance companies can, through their reinsurance programmes, limit the maximum liability arising out of a single event, a series of small claims (within the insurance company's retention limits) can affect the underwriting performance, and thereby, overall profitability. CRISIL Ratings discusses with the management and the promoters to find out their willingness and ability to infuse additional capital under extreme circumstances.

Earnings: The earnings position is key to augmenting capital required to support growth. It is a representation of how efficiently an insurance firm can price the risk being transferred from the policy holders. Lower premium charged for higher risk can lead to high claims being incurred, leading to losses. Higher premium charged for lower risk can impact the market position of the insurance company, eventually leading it out of the market. Earnings also influence an insurance company's ability to attract capital. CRISIL Ratings factor earnings from both heads of income for an insurance company, viz. the underwriting business and investment book.

Liquidity and financial flexibility: Liquidity represents an insurance company's resource strength and the support available to it to meet policyholder obligations. The liquidity position is also a function of the management's policy of maintaining a treasury portfolio to meet liquidity demands. The primary sources of liquidity include underwriting, operating cash flow, and the investment portfolio.

CRISIL Ratings also analyses if the insurance company has cash call facilities from its reinsurers to meet large claims. Cash call facilities constitute an additional feature of the company's overall reinsurance programme.

Insurance companies are also expected to have adequate financial flexibility. A line of credit facility from banks to meet short-term liquidity requirements and capital commitment from promoters are important sources of financial flexibility.

Management risk

Quality of management is a key differentiator with respect to future performance of an insurance company. Managements are evaluated based on their goals and strategies, appetite for risks, ability to manage and control risks, integrity, depth, and stability. Management risk can constrain the standalone rating in case of poorly managed firms.

Parent support

Assessing the level of parent support is an important feature of CRISIL Ratings' rating methodology. While evaluating parent support, CRISIL Ratings factors in the economic rationale and moral obligation of the parent towards its insurance subsidiary.

The economic rationale captures the strategic importance of the insurance company, the economic incentive for the parent to support the venture, and current and prospective ownership structure. An assessment of the parent's moral obligation towards the company includes a study of the management's control, common branding or name sharing and its stated posture towards supporting the insurance subsidiary on an ongoing basis and under distress. The parent's financial strength also plays a pivotal role in assessing the overall support that it would extend to the insurance venture.

Conclusion

CRISIL Ratings considers business mix and competitive position in the segments of operation, policy on underwriting and reinsurance, investment policy and quality, risk management, capitalisation, earnings, and liquidity as the key business and financial risk parameters that drive the ratings on a general insurance company. These parameters determine the company's ability to underwrite, price and manage its risks, generate sufficient returns, and maintain adequate capital for loss-absorption, liquidity, and growth.

Key ratios used by CRISIL Ratings while rating general insurance companies

Claims ratio = Net incurred claims / Net premium earned

Net incurred claims are the total claims incurred in a given time period, both paid and outstanding claims including IBNR/IBNER² reserves, net of the claims recovered from the reinsurers.

Net premium earned is the actual premium income of an insurer net of premium deficiencies and total premium payable to the reinsurers.

General insurance typically has short-term liabilities, and its success is majorly driven by how these companies can assess risk while underwriting policies. Claims ratio, measured as ratio of net incurred claims to net premium earned, indicates the adequacy of pricing with regards to the underwriting risks inherent in the business. Higher proportion of risky policies written can lead to higher claims being incurred (higher claims ratio) and vice versa.

Expense ratio = (Operating expense + Commission expense) / Net premium written

The operational efficiency of insurance companies is measured by expense ratio. Expense ratio captures the operational cost of underwriting policies as well as the commission paid to the insurance agents and is used as one of the measures of profitability. Higher the expense ratio, lower is the operational efficiency and therefore underwriting profitability.

Combined ratio = Claims ratio + Expense ratio

Combined ratio represents the overall business efficiency of an insurance firm. This includes value of claims incurred, and the operational as well as commissioning expenses borne while underwriting policies. The ratio represents overall business expenses of the insurance company as a proportion of the premium. Higher the ratio, lower will be the underwriting/operational profitability and vice versa.

Solvency ratio = Available solvency margin / Required solvency margin

Solvency ratio is a measure of adequacy of capital against the underwriting risks inherent in the business and growth of an insurance company. IRDAI stipulates a minimum solvency margin ratio that needs to be maintained by all insurance companies to ensure their steady state financial health.

The numerator in solvency ratio – available solvency margin is an indicative measure of capital cushion and profitability of an insurance company. It is the excess of assets over liabilities of policyholders' funds and shareholders' funds of an insurer.

The denominator in solvency ratio is calculated using a methodology prescribed by the regulator. The regulator requires all the insurance companies to always maintain a minimum excess of assets over the liabilities - required solvency margin (RSM). RSM is a factor of the risk inherent to the underwriting business as well as the investment portfolio of an insurance company. Higher the risk an insurer takes, higher RSM will be applicable to it and vice versa. E.g., Exposure to crop insurance segment would require maintenance of higher RSM when compared to exposure to fire insurance segment.

² IBNR: claims incurred but not reported, IBNER: claims incurred but not enough reported

Return on investment (RoI) = Investment income / Average total asset under management (AUM)

Insurance companies' profitability is typically categorised under two heads. The first head includes profit made purely from the insurance underwriting business. The other is investment income which the insurance company makes by investing the assets it owns under both policyholder and shareholder account into various securities. These investments are regulated as per IRDAI (Investment) Regulations. RoI indicates the returns generated on deployment of assets as investments. Consistently higher ratio indicates better performance of the investment portfolio.

Return on equity = Profit after tax (PAT) / Net worth

Return on equity is a measure of the profits generated by an insurance company vis-à-vis the value of shareholders' fund. Consistently higher return on equity indicates better utilisation of the shareholder's funds.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings Limited

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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