

CRISIL Criteria for Rating Hybrid Instruments Issued by Insurance Companies

Executive summary

Insurance companies in India are now allowed to raise additional capital through subordinated debt or preference shares (*referred to as hybrid instruments*). These instruments qualify as capital and will help insurers improve their solvency margins.

CRISIL's rating criteria on hybrid instruments start with an assessment of overall credit quality of insurers through Financial Strength Ratings (*FSR; refer to CRISIL's Rating Criteria for General Insurance Companies and Life Insurance Companies at www.crisil.com*). The instruments are then tested for additional risk factors to determine whether their ratings should be lower than, or the same as, FSR.

Hybrid instruments to be issued by insurers have risk features similar to Upper Tier II bonds issued by banks under Basel II regulations. They carry additional risks on account of restriction on debt servicing¹ if the solvency ratio of insurers falls below the regulatory stipulation. Further, in case of insufficient profit or loss, approval from the Insurance Regulatory and Development Authority of India (IRDA) is required to service these instruments.

CRISIL's rating criteria incorporates these risks by evaluating the expected cushion in solvency ratio that the insurer intends to maintain -- over and above the regulatory stipulation -- on an ongoing basis. Majority of insurers are promoted by large established companies. Hence the stance of the promoters on infusing equity to enable insurers to maintain solvency ratio cushion will also be a critical factor in arriving at the rating of hybrid instruments.

CRISIL's rating criteria for preference shares issued by insurance companies, in addition to these factors, shall also consider the adequacy of free reserves to make dividend payments in the event of inadequate profit.

Scope

This criteria document covers the rating methodology for subordinated debt and preference share instruments proposed to be issued by insurance companies in India.

¹ The IRDA guidelines on insurance hybrid instruments do not specify the restrictions on principal payment. However, CRISIL believes the restrictions applicable to coupon/dividend payments will apply to principal payment, too.



Background and overview

The insurance sector in India has multiple private and public players in both the life and general insurance sectors. Prior to the IRDA guidelines permitting the issue of hybrid instruments to raise additional capital, insurance companies could do so only through equity infusion. What hybrid instruments will do is strengthen the financial flexibility of insurance companies, improve capital availability to them, and contribute towards increasing penetration of insurance in India.

Features of hybrid instruments

	Features for subordinated debt instruments and preference shares
Maturity	Perpetual or minimum tenure of 10 years. Only exception is for health insurance companies which can issue instruments of 7-year tenure.
Interest/dividend	Fixed or floating as per benchmark
Discretion to defer payments	<ol style="list-style-type: none"> 1. No voluntary discretion to defer payments. 2. Cancellation of interest payment shall not impose any restriction on the insurance company except on payment of dividend to equity shareholders
Options	<ol style="list-style-type: none"> 1. No put option allowed 2. Call option allowed to be exercised after 5 years
Regulatory requirements for making interest/dividend and principal payments²	<ol style="list-style-type: none"> 1. Maintaining solvency ratio as per regulatory stipulations 2. In the event of loss, prior approval from IRDA is required before making such payments 3. No loss absorption features that could result in compulsory conversion to equity
Cumulative	<ol style="list-style-type: none"> 1. Interest payments on subordinated debt instruments are cumulative and will be allowed in subsequent financial years with the approval of IRDA and if the solvency ratio is in line with regulatory stipulation 2. Preference shares are non-cumulative in nature
Seniority of claims	<ol style="list-style-type: none"> 1. Claims of subordinated debt holders are superior to those of preference and equity shareholders, and subordinated to the claims of policy holders and all other creditors 2. Claims of preference shareholders are superior to equity share holders

Hybrid instruments qualify as capital for the purpose of calculating the solvency ratio. However, when calculating the ratio, they shall be subjected to progressive haircut on straight-line basis in the final five years to maturity. The maximum amount that can be raised through hybrid instruments is 25% of the equity capital and securities premium, and the amount shall not exceed 50% of the networth of the insurance company.

² The IRDA guidelines on insurance hybrid instruments do not specify the restrictions on principal payment. However, CRISIL believes the restrictions applicable to coupon/dividend payments will apply for principal payment, too.

Comparison with Upper Tier II instruments issued by banks under Basel II Guidelines:

The broad characteristics of hybrid instruments are similar to Upper Tier II bonds issued by banks under Basel II regulations, which are subordinated to depositors and general creditors. The risk of non-payment of principal and interest on Upper Tier II bonds is linked to the capital adequacy ratio of banks falling below regulatory minimum threshold (9%). Payment on these bonds also requires regulatory approval in the event of a loss.

Rating Criteria for Insurance Hybrids

Financial Strength Rating for insurance companies

CRISIL's rating criteria on hybrid instruments start with an overall assessment of the credit quality of the insurance company measured by its ability to meet obligations to policy holders. CRISIL's criteria for Financial Strength Ratings (FSR) for insurance companies capture this aspect by analysing them on a standalone basis and assessing the level of parental support they receive.

CRISIL's rating methodology for FSR of insurance companies is based on a comprehensive study of the risks involved in the insurance business and covers industry risk, business risk, financial risk and management risk. Business risk is analysed using the parameters of market position and risk management. Financial risk is analysed using the parameters of investment policy and quality, capital adequacy, earnings and liquidity. (Refer to *Rating Criteria for General Insurance Companies and Rating Criteria for Life Insurance Companies at www.crisil.com*). Then support of parent is also factored in to arrive at the final FSR. Parental support is assessed by evaluating the economic rationale of the subsidiary to the parent, and the moral obligation of the parent to support the subsidiary, which can manifest as timely infusion of funds, sharing of expertise, sharing of common brand, etc. (Refer to *'Criteria for Notching up Standalone Ratings of Companies Based on Parent Support at www.crisil.com*).

Risks associated with insurance hybrids

In addition to parameters under FSR for insurance companies, CRISIL's rating criteria for hybrid instruments also takes into account the following key risk factors:

- **Risk associated with the solvency ratio falling below the regulatory minimum:** Insurers have to maintain solvency ratio as per regulations (currently the minimum is 1.5). This implies that if the solvency ratio falls below the minimum, even though the insurance companies have adequate resources to service hybrid instruments, they shall not be allowed to do so. As per CRISIL's criteria, an event resulting in non-servicing of hybrid instruments on a timely basis would constitute a default.

Hence CRISIL believes this feature is an additional risk to hybrid instruments apart from credit quality evaluated through CRISIL's methodology on FSR for insurers.

- **Risk of servicing the instruments in the event of loss:** Insurance companies will need approval from IRDA to service these instruments if they report a loss in any financial year and despite maintaining solvency ratio as required.



In the financial sector, we have observed that banks were permitted by the Reserve Bank of India to service regulatory capital instruments even when they reported losses. Such approvals were granted where capital adequacy was above the regulatory minimum of 9%. CRISIL believes that in the event of loss or inadequate profit, IRDA may permit insurers to service the instruments, subject to them maintaining solvency ratio as required.

Hence the primary risk associated with hybrid instruments is non-payment in the event solvency ratio falls below the regulatory stipulation.

Reasons for changes in solvency ratios

- **Impact of regulatory changes:** It has been observed that in the past, on account of regulatory changes, the solvency ratio of general insurers has been significantly impacted. For instance, in March 2011, IRDA required all non-life insurers including reinsurance companies to provide for liability of Motor TP (third party) pool at 153% between fiscals 2007-08 and 2010-11. This resulted in a sharp decline in the solvency ratio of non-life insurers. Subsequently IRDA relaxed the solvency ratio to below 1.5 times for the years ended March 31, 2012, to March 31, 2014, in order to enable the insurers to absorb the impact of higher reserve requirement because of changes in regulation. CRISIL believes that the factors impacting computation of solvency ratio shall remain susceptible to changes in regulation. In such circumstances, CRISIL believes IRDA will consider giving sufficient transition time to insurers.
- **Increase in claims:** Substantial increase in claims on account of aggressive business underwriting practices, geographical concentration, and higher exposure to riskier segments such as Motor TP can impact the solvency ratio. While the reserve requirement increases, assets available for computation decline as claims rise, resulting in a deterioration of the solvency ratio.
- **Business growth:** Business growth leading to significant increase in premiums can also impact the solvency ratio of insurers. The required solvency margins as well as reserve requirements increase on account of high premium growth leading to a decline in the solvency ratio.

Framework for rating insurance hybrids

CRISIL's rating of hybrid instruments begins with the assessment of the FSR of the insurer. The extent of notch-down, if any, from the FSR will depend on CRISIL's assessment of the expected solvency ratio cushion the insurer is likely to maintain over the regulatory minimum.

The cushion shall be validated against historical volatility in the insurer's solvency ratio.

If the solvency ratio expected to be maintained is significantly more than the regulatory requirement, the ratings on hybrid instruments are likely to be close to, or the same as, the FSR. On the other hand, if the expected solvency ratio of the insurer is only marginally above the regulatory requirement, the rating could be away from the FSR by as much as 3 to 4 notches.

The level of parent support is an important feature of CRISIL's rating methodology for the FSR of insurance companies. CRISIL shall analyse the parent's stance along with past track record in supporting the insurer to maintain sufficient cushion in the solvency ratio over the regulatory minimum requirement, so as to enable timely servicing of hybrid instruments.

For the rating of preference shares, in addition to all the factors mentioned above, CRISIL's methodology shall evaluate the adequacy of free reserves in order to make dividend payments in the event of inadequate profit.

Conclusion

CRISIL's rating criteria on insurance hybrid instruments recognises the unique credit risks associated with these instruments. The extent of notch-down, if any, of the hybrid instrument from the FSR shall depend on the expected cushion in the solvency ratio to be maintained above the regulatory minimum requirement, and the availability of parent support, if any, to maintain this level of expected cushion.

Additional Reading³

- Rating Criteria for General Insurance Companies
- Rating Criteria for Life Insurance Companies
- Criteria for Notching up Standalone Ratings of Companies Based on Parent Support
- Rating Criteria for Hybrid Capital in Banks
- CRISIL Rating Criteria for BASEL III-Compliant Instruments of Banks

³ These criteria documents are available at our website www.crisil.com

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About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated over 95,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments, microfinance institutions and voluntary organizations. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs). This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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