Ratings criteria for general insurance companies

February 2018
Criteria contacts

Pawan Agrawal
Chief Analytical Officer – CRISIL Ratings
Email: pawan.agrawal@crisil.com

Somasekhar Vemuri
Senior Director – Rating Criteria and Product Development
Email: somasekhar.vemuri@crisil.com

Sameer Charania
Director – Rating Criteria and Product Development
Email: sameer.charania@crisil.com

Ajit Velonie
Director - CRISIL Ratings
Email: ajit.velonie@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com
Executive summary

CRISIL has been assigning Financial Strength Ratings to insurance companies since March 1998 after assessing their ability to meet policyholder obligations. The rating methodology\(^1\) for general or non-life insurance companies entail assessing them on a stand-alone basis and the level of parent support they receive. On stand-alone basis, factors such as industry and business risks, the risk management systems, goals and strategies, and projected business plan are analysed, apart from examining the financials. Parental support is especially crucial for start-up insurance ventures, given the need to recapitalisation till they break even and begin generating profits.

Stand-alone assessment

Industry risk

The overall insurance industry is analysed based on its importance to the economy, its size and growth potential (present penetration levels and future growth prospects), entry barriers, the stability of underwriting performance as well as the 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.

Business risk

This analysis includes factors specifically influencing a particular company. These include:

**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), combined ratio, claims ratio and expense ratio. 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. Expense ratio, measured as ratio of operating expense (including net commission paid) to net premium written, indicates the adequacy of pricing with regards to operating expenses incurred in the business. Combined ratio is measured as sum of claims ratio and expense ratio while underwriting surplus (deficits) is arrived at by deducting sum of net claims incurred, net commission paid and operating expense from net premium earned.

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

The Insurance Regulatory Development Authority (IRDA) has prescribed a ranking order for the segments in terms of their relative risk profile, which is as follows:

---

\(^1\) Previous published document on “Rating criteria for general insurance companies” can be found at: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/CRISIL-Ratings-criteria-general-insurance-companies_2007.pdf
<table>
<thead>
<tr>
<th>Business Segment</th>
<th>Risk category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fire</td>
<td>Medium</td>
</tr>
<tr>
<td>Engineering</td>
<td>Medium</td>
</tr>
<tr>
<td>Rural Insurance</td>
<td>Medium</td>
</tr>
<tr>
<td>Marine-Hull</td>
<td>Medium</td>
</tr>
<tr>
<td>Marine-Cargo</td>
<td>Medium to High</td>
</tr>
<tr>
<td>Health</td>
<td>Medium to High</td>
</tr>
<tr>
<td>Liability</td>
<td>Medium to High</td>
</tr>
<tr>
<td>Motor</td>
<td>High</td>
</tr>
<tr>
<td>Aviation</td>
<td>High</td>
</tr>
</tbody>
</table>

CRISIL’s views are broadly in-line with this ranking order; it assesses the risk profile of the various business segments and their impact on the company’s overall underwriting performance. CRISIL also looks at the segment-wise claims ratio to assess the efficacy of underwriting performance across segments.

In the last decade, several mono-line insurers, particularly private health insurers, have emerged. Given their exposure to a single segment, CRISIL evaluates their expertise and track record looking at the nuances of the sector.

**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 aids to cap the overall loss that could devolve on the primary insurer. CRISIL assesses the level of risk retained by the insurance company by studying its reinsurance strategies, the reinsurance programmes that have been entered into, the extent of reinsurance and the financial strength and credit profile of the reinsurance companies. In order to assess the extent of retention, CRISIL assesses the reinsurance programme for each business segment (quota share treaty, surplus treaty 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 covers (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.

**Market position:** The market share in each line of business, the key competitive advantages enjoyed and synergies, if any, with the promoters’ existing operations is studied to assess the overall business strengths of a non-life insurance company. Diversity mitigates risk and hence product and geographical diversity would be evaluated.

**Asset management:** 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 examines the insurance company's investment strategy with regard to credit quality, capital appreciation, long-term safety and easy liquidity. The investment portfolio’s diversity 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 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 risk management, technology and 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 pressure and driven companies to lessen their dependence on costly manpower alone.

Financial risk

CRISIL evaluates parameters such as fund infusion plans in-line with business requirements, whether a company’s solvency ratio complies with IRDA’s stipulations and the adequacy of the solvency margin. Further, the timeframe by which operations will break-even, the liquidity plan to meet policyholder obligations, accounting policies adopted and time frame for break-even (for new startups) are critically examined.

Capitalisation: IRDA 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 addition to the solvency margin, the inherent risk of the underwriting business is captured by the capitalisation ratio, also referred to as the underwriting exposure. Capitalisation level is expressed as net premium written to networth. The lower the ratio, the less the risk exposure of an insurance company.

In 2016, IRDA 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 solvency margin above regulatory minimum as payouts to these instruments are contingent upon this.

Although general insurance companies can, through their reinsurance programme, limit their 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 studies various scenarios to determine how much capital could be required under them; it then discusses with the management and the promoters their willingness and ability to infuse additional capital under extreme circumstances.

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

This analysis also examines 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 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.
Parent support

Assessing the level of parent support is an important feature of CRISIL’s rating methodology. While evaluating parent support, CRISIL factors in the economic rationale and moral obligations 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 to support includes the management control and the management’s stated posture towards the insurance subsidiary. CRISIL evaluates the parent’s stated posture to support its 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.

The key rating drivers thus include the capital, business strategy and capital infusion plans, experience in insurance and asset management businesses, and the extent of parent support.
About CRISIL Limited

CRISIL is an agile and innovative, global analytics company driven by its mission of making markets function better. We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

We are 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

CRISIL Ratings is part of CRISIL Limited (“CRISIL”). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India (“SEBI”). With a tradition of independence, analytical rigour and innovation, CRISIL sets 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 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

CRISIL Privacy Notice

CRISIL respects your privacy. We use your contact information, such as your name, address, and email id, to fulfil your request and service your account and to provide you with additional information from CRISIL and other parts of S&P Global Inc. and its subsidiaries (collectively, the “Company”) you may find of interest.

For further information, or to let us know your preferences with respect to receiving marketing materials, please visit www.crisil.com/privacy. You can view the Company’s Customer Privacy at https://www.spglobal.com/privacy

Last updated: April 2016