Rating criteria for life insurance companies

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Executive summary

CRISIL has been assigning Financial Strength Ratings to insurance companies since March 1998, after assessing their ability to meet policyholder obligations. Companies are evaluated on a standalone basis, and also based on the parent support they receive. On a standalone basis, factors such as industry and business risks, risk management systems, investment quality, goals and strategies, and projected business plan are analysed, in addition to examination of the financials and liquidity. Parental support is crucial especially for start-up insurance ventures, given the need for recapitalisation, until they break even and start generating profit.

Standalone 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 growth prospects), entry barriers, stability of underwriting performance, and regulations 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 is an analysis of specific factors influencing a company, including:

Business mix: The projected business plan is studied to understand a company’s commitment to prudential underwriting standards.

A life insurance company can offer both, life and annuity products. Life insurance supports families of those who die early, whereas annuities are a stable source of income. Nevertheless, life products can combine features of an annuity; and annuity products can also be designed to provide life cover.

Death of a life insurance policyholder at a young age, entails meeting obligations from an earlier date, whereas prolonged life of an annuitant implies payment exceeding the estimated obligation. From a risk perspective, both these situations can result in a loss for the insurance company, and hence, the business mix has to be an optimal combination of life policies and annuities.

Like business diversity, product diversity is also important. Life insurance companies offer both unit-linked investment plans (ULIPs) and traditional policies. Through ULIPs, the companies provide a life cover along with an investment option to the policyholder. A small part of the premiums received from policyholders in ULIPs, is set aside as premiums pertaining to non-participating life cover, and the balance amount is invested in a fund of the policyholders’ choice. The net asset value (NAV) of a fund is impacted by ups and downs in the capital market. The NAV may show a rise or a fall, depending on volatility in equity markets or interest rates. Investment risks in ULIPs, arising from

1 Previous published document on “Rating criteria for Life Insurance companies” may be found at: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/CRISIL-Ratings-criteria-life-insurance-companies_feb2018.pdf
movement in NAVs, is entirely borne by policyholders, and hence, the profit margin of insurance companies offering ULIPs tend to be low.

Traditional policies can be bifurcated into non-participating and participating policies. In a non-participating policy, an insurance company promises a guaranteed benefit to the policyholder, as a life cover in term policies, annuity cover in pension and annuity products, and a life cover along with guaranteed returns in endowment policies. Investment risk in these policies are entirely borne by insurance companies and hence, the profit margin is higher. The profit margin of insurance companies in participating policies is moderate, as companies share the risks and rewards with policyholders, in the form of bonuses and dividends.

Diversity in geographic reach is equally important, as sizeable exposure to a single state or district exposes a life insurance company to catastrophic and pandemic risks, in addition to other related risks.

An insurance company with a balanced product mix, diversified geographic presence, established brand and superior competitive positioning is likely to have a more stable business risk profile.

Pricing: As life products are a combination of savings and life cover, the prevailing interest rate plays a critical role in their pricing. Besides, pricing is dependent on the mortality rate, age at entry, product features (with profit and without profit policies) and other features such as occupational risk, family and health history and personal habits. For annuity products, pricing is based on the annuitant’s longevity or survival rate.

Underwriting policy: Sound underwriting guidelines and their ability to manage associated risks are pivotal to the long-term solvency of an insurance company. For life insurance companies, payments to policyholders include claims due to death, surrender of policy or its maturity. Unlike non-life insurance, it is relatively easier to estimate liabilities in life insurance, as the risk of death can be fairly projected, based on historical mortality rates. The analysis attempts to capture the mortality table adopted by the life insurer and estimate the actual claims (mortality) faced by the company. However, the survival rate or longevity of a policyholder is increasing gradually, due to sustained improvement in healthcare services. This in turn, involves higher uncertainties in estimation of liabilities pertaining to annuity or pension policies. Contribution of these policies in the overall premiums of life insurance companies though is low, so far.

Selection of the life insured is a critical element in the underwriting process. Life insurance companies need to initiate systems to mitigate adverse selection. Critical factors comprise occupational profile, male-female ratio and the insured portfolio’s age group.

Distribution channel: As life insurance targets individuals, a wide and strong retail distribution network is required to generate business volume. Besides, individuals need to be provided with appropriate counseling to protect themselves through life covers. This is an educative process and converting prospective customers into effective insured clients has its own gestation period. The analysis captures the effectiveness of a distribution channel set up by an insurance company. A wide distribution channel is critical for growth and for optimising distribution expenses.

The profile of agents, in terms of their qualifications, age groups and experience, is also important. For start-up companies, motivation and training is critical as retaining agents is another key aspect. This has implications on the agents’ productivity, policy lapses and surrenders, which, in turn, impacts marketing cost. Productivity parameters for agents include first year premium income generated and sum insured per agent.

Business originating from corporate agents, especially banks, has increased during the past decade. The internet too is emerging as an important channel.

Reinsurance policy: Reinsurance facilitates diversification of an insurance company’s underwriting risks amongst a pool of reinsurers, besides increasing the underwriting capacity. The level of risk retained by an insurance company
is examined by studying its reinsurance strategies, programmes it has entered into, extent of reinsurance, and its financial strength and credit profiles.

**Investment quality:** Prudent management of the investment portfolio is critical for bolstering overall performance of an insurance company. Appropriate systems, judicious investment policies and internal controls are essential components of fund management.

Life insurance is a long-term product. Premiums received from policyholders are invested in short-, medium- and long-term assets. Investment inflows (interest and principal on maturity) are utilised to meet policyholder obligations. The investment strategy should focus on asset quality, containing asset-liability mismatches and maximising yield on investments. In fact, some of the factors that have led to poor performance of insurance companies globally, include an asset-liability mismatch, poor quality of asset portfolios and low return on investments.

This analysis captures the company’s investment strategy, in terms of credit quality, capital appreciation, long-term safety and easy liquidity. The investment portfolio’s diversity across industries and companies, along with single risk concentration limits, are important to determine the overall asset quality.

**Technology and risk management:** Technology to support timely delivery of products and efficient risk management are critical. Appropriate systems facilitate better risk selection, pricing of products, monitoring legitimacy of claims and quick settlements.

Persistency and conservation ratios are also evaluated to assess the efficacy of the life insurance company. Persistency ratio is calculated as the total number of policies renewed in the current year, expressed as a percentage of the total number of policies outstanding in prior years. Conservation ratio represents the total renewal premium collected in the current year, expressed as a percentage of total premium collected in the previous year.

**Financial risk**

Fund infusion plans, in line with business requirements, are scrutinised, to confirm whether the company’s solvency ratio complies with Insurance Regulatory and Development Authority (IRDA)’s stipulations, and to verify the adequacy of the solvency margin. This is critically examined for companies who are at a nascent stage of operations, and yet to achieve break-even. This is also examined for companies growing at a pace higher than that supported by their internal accruals.

**Capitalisation:** IRDA has prescribed a minimum start-up capital of Rs 1 billion for life insurance companies. To ensure the company’s safety and financial health, IRDA has specified the solvency margin to be maintained by all life insurers. In addition to regulatory compliance, the analysis considers adequacy of the solvency margin projected by an insurance company.

In 2016, IRDA allowed issuance of hybrid instruments to supplement the capital requirement, thereby boosting available solvency margin of several insurers. This would ensure the solvency margin remains above the regulatory minimum, as payouts to these instruments are contingent on this.

Along with the reported networth and solvency ratio, the available solvency margin against economic capital requirement and market consistent embedded value, is also taken into consideration while assessing the capital position.

**Earnings profile:** A life insurance business takes a while to break-even and report profits. While all the expenses and reserve requirements have to be met in the first year of underwriting itself, profitability improves over a period of time, in line with growth in scale and operating efficiency. Therefore, in addition to return on equity, other metrics
such as value of new business margin and return on embedded value are also factored in, if available, while assessing the earnings profile of a life insurance company.

**Liquidity and financial flexibility:** This parameter looks at an insurance company’s resource strength and liquidity support available to meet policyholder obligations. Primary sources of liquidity include underwriting cash flow, operating cash flow and investment portfolio liquidity. A line of credit facility from banks to meet short-term liquidity requirement is an additional plus point. Timely and need-based funding commitment from promoters is also critical because insurance companies are expected to have adequate financial flexibility.

Surrender, lapse and cancellation of policies can weaken liquidity of life insurers. Hence, the mechanism set up by the company to cope with such eventualities, remains vital.

**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.

**Parent support**

In this case, the economic rationale and moral obligations of the parent towards the insurance subsidiary is inspected.

The economic rationale captures the strategic importance of the subsidiary, the economic incentive for the parent to offer support, along with the current and prospective ownership structures. An assessment of the parent's moral obligation to provide support involves evaluation of factors such as management control and its stated posture towards the insurance subsidiary. The parent's stated posture to support its subsidiary on an ongoing basis and under distress is hence evaluated.

Key rating drivers include the solvency position, risk management practices, competitive positioning, investment quality, profitability and the extent of parent support.
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It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers. 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.

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