CRISIL
Ratings

Rating criteria for hybrid instruments issued by insurance companies

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Criteria contacts

Somasekhar Vemuri
Senior Director and Head
Rating Criteria, Regulatory Affairs and Operations
Email: somasekhar.vemuri@crisil.com

Ramesh Karunakaran
Director
Rating Criteria and Product Development
Email: ramesh.karunakaran@crisil.com

Mayank Devpura
Associate Director
Rating Criteria and Product Development
Email: mayank.devpura@crisil.com

Vishal Raj
Analyst
Rating Criteria and Product Development
Email: vishal.raj@crisil.com

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

Executive summary

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

CRISIL Ratings' criteria for hybrid instruments start with an assessment of the overall credit quality of insurers through corporate credit rating (CCR) — *for details on how CCR is determined for insurers, refer to CRISIL Ratings' criteria for general insurance companies and life insurance companies, at www.crisil.com*. These instruments are then tested for additional risk factors to determine whether their ratings should be lower than, or the same as, CCR.

Hybrid instruments 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 restrictions on debt servicing 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 (IRDAI) is required to service these instruments.

CRISIL Ratings' criteria incorporate these risks by evaluating the expected cushion in the solvency ratio that the insurer intends to maintain — over and above the regulatory stipulation — on an ongoing basis. The majority of insurers are promoted by large established companies. Hence, the stance of the promoters on infusing equity to enable insurers to maintain a solvency ratio cushion is also a critical factor in arriving at the rating of hybrid instruments.

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

Scope

This criteria[1] document covers the rating methodology for subordinated debt and preference shares (termed as other forms of capital by IRDAI) issued by insurance companies in India.

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 IRDAI guidelines permitting the issue of hybrid instruments to raise additional capital, insurance companies could do so only through equity infusion. What hybrid instruments do is strengthen the financial flexibility of insurance companies and improve capital availability to them.

[1] *To access the previous criteria document, please follow below link: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/crisils-criteria-for-rating-hybrid-instruments-issued-by-insurance-companies-may2020.pdf*

Features of hybrid instruments

	Features of 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	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 share holders
Options	1.	No put option allowed
	2.	Call option allowed to be exercised after 5 years
Regulatory requirements for making interest/dividend and principal payments[2]	1.	Maintaining solvency ratio as per regulatory stipulations
	2.	In the event of loss, prior approval from IRDAI is required to make such payments
	3.	No loss absorption features that could result in compulsory conversion to equity
Cumulative	1.	Interest payments on subordinated debt instruments are cumulative and will be allowed in subsequent financial years with the approval of IRDAI and if the solvency ratio is in line with regulatory stipulation
	2.	Preference shares are non-cumulative in nature
Seniority of claims	1.	Claims of subordinated debt holders are superior to those of preference and equity shareholders, and subordinated to claims of policy holders and all other creditors
	2.	Claims of preference shareholders are superior to those of 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 a straight-line basis in the final five years to maturity. As per IRDAI, 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.

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 the regulatory minimum threshold (9%). Payment on these bonds also requires regulatory approval in the event of a loss.

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

Rating criteria for insurance hybrids

CCR of insurance companies

CRISIL Ratings' criteria for 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 Ratings' criteria for CCR of insurers capture this aspect by analysing them on a standalone basis and assessing the level of parental support they receive.

CRISIL Ratings' methodology for CCR of insurance companies is based on a comprehensive study of the risks involved in the insurance business and covers business risk, financial risk, and management risk. Business risk is analysed using the parameters of market position, investment policy and quality, and risk management. Financial risk is analysed using the parameters of capital adequacy, earnings, and liquidity.*

Support of the parent is also factored in to arrive at the final CCR. 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 a 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 the parameters under CCR for insurance companies, CRISIL Ratings' criteria for hybrid instruments also take into account the following key risk factors:

- **Risk associated with the solvency ratio falling below the regulatory minimum:** Insurers have to maintain the 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 Ratings' criteria, an event resulting in non-servicing of hybrid instruments on a timely basis would constitute a default.

Hence, CRISIL Ratings believes this feature is an additional risk to hybrid instruments apart from credit quality evaluated through CRISIL Ratings' methodology for CSR of insurers.

- **Risk of servicing instruments in the event of loss:** Insurance companies will need to take approval from IRDAI in cases where servicing debt instruments results in a net loss to them or increases their net loss. 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 Ratings believes that in the event of loss or inadequate profit, IRDAI may permit insurers to service instruments, subject to them maintaining the solvency ratio as required.

Hence, the primary risk associated with hybrid instruments is non-payment in the event the 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. CRISIL Ratings believes that the factors impacting computation of the solvency ratio will remain susceptible to changes in regulation. In such circumstances, CRISIL Ratings believes IRDAI will consider giving sufficient transition time to insurers.

**This paragraph was updated in August 2024 to address a typographical oversight.*

- **Increase in claims:** A substantial increase in claims on account of aggressive business underwriting practices, geographical concentration, and higher exposure to riskier segments such as motor third party (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 a 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 Ratings' criteria for hybrid instruments begin with the assessment of CCR of the insurer. The extent of notch-down, if any, from CCR will depend on CRISIL Ratings' 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 rating on hybrid instruments is likely to be close to, or the same as, CCR. 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 CCR by as much as three to four notches.

The level of parental support is an important feature of CRISIL Ratings' methodology for CCR of insurance companies. CRISIL Ratings shall analyse the parent's stance along with 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.

In some cases, IRDAI has allowed insurers to service their subordinated debt, even when their solvency ratios have fallen below the regulatory minimum. CRISIL Ratings factors in such regulatory nuances while deciding the notch-down from CCR, to arrive at the rating of the insurance hybrid.

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

Conclusion

CRISIL Ratings' criteria for insurance hybrid instruments recognise the unique credit risks associated with these instruments. The extent of notch-down, if any, of the hybrid instrument from CCR depends on the expected cushion in the solvency ratio to be maintained above the regulatory minimum requirement, and the availability of parental support, if any, to maintain this level of expected cushion.

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Argentina | China | Hong Kong | **India** | Poland | Singapore | UK | USA | UAE
CRISIL Limited: CRISIL House, Central Avenue, Hiranandani Business Park, Powai, Mumbai – 400076. India
Phone: + 91 22 3342 3000 | Fax: + 91 22 3342 3001 | www.crisil.com
/company/crisil @CRISILLimited /CRISILLimited /user/CRISILLimited /lifeatcrisil