

## INSURANCE INSIGHTS | MACRO STRATEGY

# Gauging S&P's Proposed Changes to Its Risk-Based Capital Adequacy Methodology

## Discussion

Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Jingsu Pu, Global Head of Insurance Strategy and Solutions at MIM, to dig through the proposed changes S&P Global is considering to its Insurer Risk-Based Capital Adequacy Methodology. Jingsu will help assess what it could mean for insurers and their ratings.

**Guy:** *It is my understanding that S&P Global Ratings withdrew its December 2021 proposal to change its capital adequacy methodology but then reissued another proposal on May 9, 2023. Why?*

**Jingsu:** This is, in fact, common. The initial proposal by S&P Global Ratings was a 'request for comment.'<sup>1</sup> After receiving feedback from market participants, helpful and improved updates to the previous proposal were made, and the new proposal has been issued once again with a request for new comments.

**Guy: Why is there a proposal to make changes in the first place?**

**Jingsu:** Let's first remember the goal, which is to measure and analyze the capital adequacy of insurance and reinsurance companies worldwide in order to apply the most accurate rating possible. It makes sense for S&P to continually look for ways to improve its methodologies. S&P believes these proposals will enhance global consistency and transparency as well as improve its ability to differentiate risk and usability by consolidating criteria and reducing certain areas of complexity.<sup>2</sup> Methodology upgrades also stem from regulatory developments, data gathering enhancements and an expanded ability to draw relevant criteria from various other internal and external frameworks.

**Guy: You mentioned global consistency is one reason for the proposed change. How is that possible, given numerous variations in global accounting standards, regulatory regimes and complex legal structures, which all must have an impact on insurance company capitalization?**

**Jingsu:** It's a good point. It is very difficult to achieve a high level of consistency at the global level. S&P made a solid effort. Its methodologies take many factors into account, and the proposed changes should do an even better job. S&P expresses its capital and earnings opinion by comparing total adjusted capital with risk-based capital requirements at different confidence levels ranging from 99.5% to 99.95%. To account for regional differences, S&P introduces a few region-specific risk categories with different level of risk charges.<sup>3</sup> The idea is that through a combination of a broadly consistent global framework, along with a few important and realistic differentiating factors among regions, the revised S&P capital adequacy methodology can enhance overall global consistency and rating comparability.

**Guy: The changes all seem to be about the recalibration of insurer risks, so what is the rationale for choosing different confidence levels?**

**Jingsu:** S&P has revised its confidence levels to four different confidence levels of 99.5%, 99.8%, 99.95% and 99.99%.<sup>4</sup> For example, a 99.5% confidence level aligns with the potential volatility and risk exposure in a 1-in-200-year event over a one-year horizon. The three higher confidence levels are achieved by applying factors of 1.2x, 1.4x and 1.65x relative to the results of

99.5% risk charges, based on accepted actuarial and statistical techniques. These numerical confidence levels approximately replace the four different letter rating levels of BBB, A, AA and AAA in the past. S&P said that selecting the confidence levels was to ensure that the outcomes preserve rank ordering and risk differentiation consistent with its insurance rating framework.

**Guy: S&P is proposing changes to its Total Adjusted Capital (TAC) calculations. What are the likely changes and impact?**

**Jingsu:** The goal of the proposed TAC calculation changes is clarification, simplification and alignment. TAC calculation starts with shareholders' equity for public insurers and surplus for mutual ones, and then makes various adjustments and judgment calls along the way to derive the final TAC.

One of the new methodologies would include changes to tolerances for debt-funded capital. The May 2023 revised proposal provides a much more detailed definition for what qualifies as "debt-funded capital." It breaks out the criteria for both the holding company and the non-operating holding company, which may fall outside of the regulatory perimeter.



It can get complicated, but the new definition considers whether the capital from the debt instrument is available and able to absorb losses through coupon deferral or cancellation, or through principal deferral, write-down or conversion, without causing an event of default. The bottom line is that S&P is looking to see if the proceeds from the debt instrument are available to the regulated operating entities to absorb losses on a going-concern basis. Hybrid capital securities are addressed separately and individually, and are typically subjected to higher tolerance thresholds.

**Guy:** *I would think that depending on whether statutory financials or GAAP financials are used, S&P could get different results. How do they rectify this issue?*

**Jingsu:** For some U.S.-based insurers, particularly life insurers, both are produced. Regardless, S&P takes these factors into account to decide which are better suited for its capital analysis. Statutory reports typically do not include the holding companies that issued the debt and hybrid securities, so S&P may calculate adjusted common equity (ACE) using GAAP financials solely for the purpose of determining the debt-funded capital and hybrid tolerances, and then incorporate these tolerances into the statutory-based capital analysis.<sup>5</sup>

Since U.S. holding companies are outside the regulatory boundary, the proceeds of debt-funded capital retained at the holding company is subject to a 20% haircut in determining TAC resources, while proceeds used to fund nonregulated activities would not be eligible for inclusion in TAC.

**Guy:** *What else can you think of that stands out as a change from the earlier proposal?*

**Jingsu:** We've discussed TAC, the numerator for capital ratio calculation. The denominator is an insurer's Risk-Based Capital (RC) that is often more insurance and insurer-specific, and computationally heavy. There are three high-level points about RC I want to add.

- 1: S&P's RC framework is highly consistent with other principal-based regulatory capital regimes globally, such as Solvency II in Europe and revised Risk-Based Capital (RBC) across Asia.
- 2: Individual risk exposure is calibrated and calculated differently, and an insurer may see an increase in many of its individual capital risk charges.
- 3: Multiple levels and recalibrated diversification may keep the overall capital requirement in check, thanks to more explicit correlation benefits.



**Guy: Let's bring this full circle and remember that the goal for S&P is to determine the most accurate rating possible given a wide variety of factors. Therefore, how will these new methodologies impact current ratings?**

**Jingsu:** I find it useful to think of the impact like a waterfall.

First level of impact is on capital and earnings in an insurer's financial risk profile. Approximately 30% of that calculation can be affected.

Second level is an insurer's standalone credit profile, where financial risk is one key anchor, together with business risk as the other anchor. S&P estimates 20% of the standalone credit profile will have an impact.

Third level is an issuer's rating, where 10% may see a change, more up than down.

S&P stated that the majority of rating actions would be one notch, with more upgrades than downgrades.<sup>6</sup> The upgrades would mostly be based on adequately capturing the diversification benefits explicitly, and they would include standalone improvements to TAC resulting from the removal of various haircuts to liability adjustments and non-deduction of non-life deferred acquisition costs. For others, however, changes to debt-funded capital limits and eligibility factors, and recalibration of risk charges to higher confidence levels, could lead to declines in capital adequacy.

**Guy: Does S&P take the ratings of other rating companies into account?**

**Jingsu:** Initially S&P proposed significantly penalizing insurers holding instruments not rated by S&P. S&P proposed lowering the ratings by Moody's and Fitch by

one to three notches, but following extensive feedback, S&P revised its stance. The May 2023 proposal still prioritizes use of S&P ratings where available. In the absence of an S&P rating, S&P will rely on a Credit Rating Agencies (CRA) mapping table, whereby it uses the lowest available rating where multiple ratings are available.<sup>7</sup>

**Guy: When do you expect these changes to take place?**

**Jingsu:** The latest request-for-comments deadline is June 30th. I suspect S&P will quickly assess the feedback and issue a final announcement of changes shortly thereafter. I do not expect any dramatic changes from those now proposed in the May 2023 request for comments.

**Guy:** It seems it can get very complicated, with many aspects to take into account. Yet, S&P appears be on top of it — having considered and implemented earlier feedback in the new proposals that will ultimately result in changes that improve S&P's methodologies and ratings.

**Jingsu:** I agree. Absolutely.

#### Endnotes

<sup>1</sup> ARCHIVE | Criteria | Insurance | Request for Comment: Request For Comment: Insurer Risk-Based Capital Adequacy--Methodology And Assumptions | S&P Global Ratings (spglobal.com)

<sup>2</sup> IBID

<sup>3</sup> IBID

<sup>4</sup> IBID

<sup>5</sup> IBID

<sup>6</sup> S&P Global Ratings Withdraws Rating Input Approach From Proposed Insurer Risk-Based Capital Adequacy Criteria | S&P Global Ratings (spglobal.com)

<sup>7</sup> IBID



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